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SECURITIES INDUSTRY STUDY

PART 3

HEARINGS
BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-SECOND CONGRESS
SECOND SESSION
ON
SELF-REGULATION IN THE SECURITIES INDUSTRY

AUGUST 8 AND 9, AND OCTOBER 5, 1972

Printed for the use of the
Committee on Banking, Housing and Urban Affairs



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SELF-REGULATION IN THE SECURITIES INDUSTRY

TUESDAY, AUGUST 8, 1972

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 2 p.m., pursuant to call, in room 5302, New Senate Office Building, Senator Harrison A. Williams (chairman) presiding.

Senator WILLIAMS. This is the hearing on self-regulation of the securities industry.

This is the Subcommittee on Securities under the full Committee of Banking, Housing and Urban Affairs.

We open a new phase of the Securities Subcommittee's 2-year study of the securities industry and securities markets, a phase which may turn out to have the greatest, long-range significance for the future of the industry and public investment in securities.

Up to now, our study has focused on immediate, substantive questions facing the industry; the paperwork crisis, commission rates, and institutional membership. These are the principal immediate concerns this committee has dealt with. These are tremendously important questions.

I believe we are making progress toward constructive solutions to these problems. For the long run, however, the most important thing we in the Congress can do is to restructure the system by which policy decisions of this nature are made. The fact that these important issues have come back to the Congress for resolution is the clearest indication that the system which was set up 38 years ago to handle them is not functioning as it should.

In too many cases, the SEC and the industry's self-regulatory agencies have been unable to handle major policy questions in a fair and orderly way.

Rather than resoliciting well-known views as to whether self-regulation has been a success or a failure, we decided to undertake case studies of how specific questions were decided by the SEC and the industry to see what the precise weaknesses are in the present system.

Two of these case studies, one dealing with the inclusion of listed securities in NASDAQ, and one dealing with the sale of life insurance by stock exchange members, have been completed and are the subject of the hearings we are holding today and tomorrow.

Two additional case studies—one dealing with the evaluation of the performance of stock exchange specialists, and one dealing with

the administration of the net capital rules, are currently in progress.

Those two studies will be the subject of additional hearings that are planned for September. I would like to emphasize these hearings are not being held for the purpose of reexamining the merits of the issues that were being decided by the SEC and the self-regulatory agencies. It is not our purpose this afternoon, for example, to determine whether listed stocks should or should not have been included in NASDAQ.

Our focus throughout these hearings will be on procedure, how the decisions were made, and whether the process was fair to all concerned. We hope that these case studies and the record compiled at these hearings will enable us to make specific recommendations for improvement of the process by which the securities industry and the securities markets are regulated.

We plan to incorporate these recommendations in the final report of the subcommittee which will be submitted by the end of this year. The subject of this afternoon's hearings is the case study on the inclusion of listed securities, as I have said, in NASDAQ.

Mr. Hamilton Wood of the study staff will summarize the findings of that case study for this hearing.

Mr. Wood, could you do that at this time?

Mr. Wood. Mr. Chairman, the case study before the Subcommittee was prepared from public sources from records and documents furnished by the Securities and Exchange Commission and the National Association of Securities Dealers, and from conversations with officials of those organizations and other persons.

The purpose of the case study is to reconstruct as fully as possible how the actual decisions were made with respect to the inclusion of listed securities in NASDAQ.

NASDAQ is an automated quotation system for the over-the-counter securities markets developed by the National Association of Securities Dealers. It went into operation on February 8, 1971. Because it was such a totally new concept, it raised a great number of technical and regulatory problems.

This case study is not intended to deal with all of those problems. Rather, it focuses on one specific question that arose during the development of NASDAQ. That question was whether the system should include the quotations of over-the-counter dealers in stocks that were also listed on national securities exchanges—the so-called third market. Because that question was of keen economic interest to the third-market firms and their customers, on the one hand, and to the stock exchanges, on the other, it put particular strain on the decisionmaking apparatus of both the NASD and the SEC. The way in which they responded to those strains is the subject of the study.

The NASD was the body with primary responsibility for deciding the question. The formal decisions of the NASD Board of Governors on the questions varied in accordance with the varying pressure brought to bear on it. Its initial policy against inclusion of listed securities in September 1968 was modified in November 1968 and completely reversed by May 1970 as a result of repeated indications from the SEC or its staff that the SEC would disapprove the exclusion of listed securities. In October and November 1970, after protests from the principal exchanges and with an indication that the SEC no longer

opposed exclusion, the NASD rapidly reinstated its earlier policy by board action to exclude listed securities. In early 1971, after the bringing of one private antitrust suit and a threat of additional suits by third-market dealers, the NASD Board consented to a "limited test" of listed securities. After studying the results of that test, it voted in May 1972 to include listed stocks in NASDAQ on a permanent basis.

The issue was never directly presented to the NASD membership as a whole. The membership did vote its general approval of the NASDAQ system in November 1968, however, on the basis of soliciting material which included a statement that listed securities would be eligible for inclusion if they met "established standards".

By law, the SEC had the power to formally "disapprove" any NASD rule dealing with NASDAQ. However, the SEC's relations with the NASD on this issue were characterized by an "informal bargaining process" that included informal discussions between their respective staffs and a "prefiling" of draft bylaws and rules. These were designed to resolve disagreements in advance and insure the Commission's nondisapproval of NASD rule changes. No public hearings were held, and the Commission made no public statement of its position on the question. Between 1968 and 1970, the NASD appears to have understood that the Commission would disapprove the exclusion of listed securities. However, in October 1970, the SEC suddenly dropped its objections, with the new Chairman reportedly taking the position that it was only the staff that had opposed the exclusion of listed securities.

While competitive considerations were of great importance in the resolution of this question, there was no formal procedure by which the requirements of antitrust law and policy could be considered in relation to other regulatory considerations. The eventual consent by the NASD to a test of listed securities in NASDAQ followed the bringing of a private antitrust suit against the NASD by one brokerage firm and a threat of such action by third-market makers. However at no time was the Department of Justice consulted with respect to the anticompetitive aspects of the proposed exclusion of listed securities.

The decisions with respect to the inclusion of listed stocks in NASDAQ pose many significant questions about the present regulatory structure of the securities industry. The statement of "Issues and Questions" at the end of the case study is designed to focus attention on them.

Mr. Chairman, that concludes the summary of this case.

Senator WILLIAMS. Thank you very much, Mr. Wood. That is a very efficient summary of the case study.

The case study, itself, complete and detailed, will be included in the record of these hearings at this point.

(The information follows):

EXAMINATION OF THE DECISIONS INVOLVED IN THE INCLUSION OF LISTED SECURITIES IN NASDAQ

INTRODUCTION

The National Association of Securities Dealers Automated Quotation System (NASDAQ) is a nationwide computer-based information system designed to provide subscribers, on a continuous and current basis with the net bid and asked prices being quoted by market makers for securities traded in the over-the-

counter markets. Although still in its relative infancy, NASDAQ is currently providing quotations for approximately 3,000 different securities.

Although the over-the-counter markets deal primarily in securities which are not listed on any exchange, there has for some time been a growing over-the-counter market in exchange listed securities. This "third market",¹ which developed to serve exchange non-members, has provided increasing competition for the exchange markets. Inclusion of the third-market quotations for listed securities in the NASDAQ system would obviously increase the visibility and effectiveness of the third market and improve its competitive position vis-a-vis the exchanges. The decision as to whether such quotations should be included, therefore, was an extremely significant question for the securities industry. The manner in which that decision was made raises fundamental questions about the operation of the present regulatory system in the securities field. Those questions are the subject of this case study.

BACKGROUND

NASDAQ received its initial impetus in 1963, when the report of the Special Study of the Securities Markets stressed the importance of reliable and up-to-date quotations in over-the-counter securities markets:

"... Interdealer and public quotation systems are vital to the operation of these markets (i.e., OTC markets) and, whether handled by private enterprise or by a self-regulatory agency, they are vested with a public interest and should be brought under appropriate supervisory control of the Commission. At the same time, the operator of any such system would be vested with authority and responsibility to regulate the use of its system by broker-dealers through appropriate rules and procedures consistent with the rules of the NASD and the Commission."²

"... there is on the horizon the likelihood of a computer system that would assemble all interdealer quotations and instantaneously determine and communicate best quotations for particular securities at any time ... Any such automated system would clearly be affected with the public interest and should be under regulatory supervision. The NASD is the natural source of leadership and initiative in dealing with matters of automation in respect to over-the-counter markets. It should actively carry forward the very limited study of automation possibilities applicable to over-the-counter markets that the Special Study has been able to undertake and should report to the Commission from time to time as to the progress and programs of the industry in this area. The Commission and the NASD should jointly consider possibilities for developing and coordinating automation programs in such manner as to fulfill their respective regulatory needs, as well as operational needs of the markets, with maximum effectiveness and minimum duplication and expense."³

In line with these recommendations, Congress in the 1964 amendments to the Securities Exchange Act further clarified the authority and responsibilities of the NASD by providing in a new Section 15A(h) (12) that:

"... the rules of the association (i.e., the NASD) 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, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and *to promote orderly procedures for collecting and publishing quotations.*" (Italics supplied.)⁴

In July 1965 the Board of Governors of the NASD announced the appointment of a special Automation Committee made up of seven members to investigate the feasibility of automated quotations in the over-the-counter market.⁵ Simultaneously, representatives of the Automation Committee and the NASD staff began frequent conferences with the Commission and the staff of the Division

¹ The third market is so called to distinguish it from (1) the Exchange markets and (2) the over-the-counter markets in unlisted securities.

² SEC, "Report of Special Study of Securities Markets," pt. 2, H. Doc. No. 95, 88th Cong., 1st sess. at 674 (1963).

³ Id. at 678.

⁴ Securities Exchange Act of 1934 (hereinafter cited as Exchange Act) H. Rept. No. 1383, 73d Cong., 2d sess. at sec. 15A(h) (12) (1934).

⁵ National Association of Securities Dealers, Inc. (hereinafter NASD) press release No. 3768, July 20, 1965 at 2.

of Trading and Markets to consider in substantial detail the development and regulation of the contemplated system.⁶ On February 2, 1967, the NASD announced that an independent management consulting firm, under the direction of the Automation Committee, would conduct a study of the economic feasibility of the use of data processing equipment in the collection and dissemination of quotation information in the over-the-counter market.⁷ The findings of the consultant and detailed specifications concerning a proposed NASD automated quotations system "NASDAQ" were made public to any and all potential bidders in 1968.⁸ Following consideration of cost, design, and operation proposals received from these firms, the Automation Committee recommended that the Board select the firm which, in its opinion, could best supply and operate the physical equipment for the system under the direction and supervision of the NASD.⁹ In December of 1968, after adoption by membership vote the NASD by By-Law Amendments authorizing establishment of the NASDAQ system and adoption by the Board of Governors of rules governing operation access to the system, the NASD signed a 7-year contract with the Bunker-Ramo Corporation to build and operate the system.¹⁰ The system became operational on February 8, 1971.

The NASDAQ system provides three "levels" of access. Level I provides a current representative interdealer bid and asked price for any security registered in the system for the information of registered representatives and customers of retail firms. Level II is for use by firm trading departments and supplies upon request a list of market makers, together with their respective bid and asked prices for each security registered in the system. Level III provides input facilities allowing authorized market makers to enter changed or updated bid and asked prices. Trades are not executed through the system. Instead, after using NASDAQ to obtain a price quotation, a subscriber then consummates the actual transactions through direct telephone negotiation with the market maker.

Rules and regulations affecting the operating of NASDAQ are subject to SEC disapproval in the same manner as other rules adopted by the Association. The relevant procedures to be followed by both the NASD and SEC to obtain adoption of the proposed rules are contained in Article VII of the Association's bylaws and Section 15A(j) of the Securities Exchange Act of 1934.

Article VII of the NASD bylaws provides in part that:

"... to protect investors and the public interest to collaborate with governmental and other agencies in the promotion of fair practices and the elimination of fraud, and in general, to carry out the purposes of the Corporation and of Section 15A of the Act, the Board of Governors is hereby authorized to adopt for submission to the members . . . rules . . . and such amendments thereto as it may, from time to time deem necessary or appropriate. The Board of Governors upon adoption of such rules of fair practice . . . shall forthwith cause copies thereof to be sent to each member of the Corporation to be voted upon. If any such rules . . . are approved by a majority of the members voting, within thirty days after the date of submission to the membership, are not disapproved by the Commission as provided in Section 15A of the Act, they shall become effective rules . . . as of such date as the Board of Governors may prescribe . . ."¹¹

Section 15A(j) requires that the Association:

"... shall file with the Commission . . . any changes in or additions to the rules of the association . . . Any change in or addition to the rules . . . shall take effect upon the thirtieth day after the filing of a copy thereof with the Commission . . . unless the Commission shall enter an order disapproving such change or addition; and the Commission shall enter such an order unless such change or addition appears to the Commission to be consistent with the requirements . . . [imposed upon the Association under the Exchange Act]."¹²

⁶ SEC memorandum of meeting between representatives of the NASD and members of the SEC staff, Dec. 9, 1965.

⁷ NASD press release No. 4167, Feb. 2, 1967 at 1.

⁸ Id. at 5.

⁹ NASD press release No. 2868, Aug. 8, 1967 at 1.

¹⁰ Operating agreement between the Bunker-Ramo Corp. and NASD signed in December 1968.

¹¹ Bylaws of National Association of Securities Dealers, Inc., art. VII, sec. 1.

¹² Exchange Act at sec. 15A(j).

CHRONOLOGY

Although representatives of the NASD were previously advised informally by the Division of Trading and Markets that significant antitrust questions might be involved in any attempts to exclude exchange-listed securities from the NASDAQ System, the Commission did not inform the NASD Board of Governors of its reservations until early April, 1968. At its March 20, 1968 meeting, the Commission requested the staff to prepare a letter to the NASD concerning potential problems of access to the NASDAQ System. In addition, Manuel F. Cohen, Chairman of the SEC, indicated he would also discuss the matter with Richard Walbert, President of the NASD.¹³ On April 10, Irving M. Pollack, Director of the SEC's Division of Trading and Markets, wrote to Walbert with regard to the NASD's proposed exclusion of listed securities:

"... the Commission believes that it is important that consideration be given to the possible impact of the provisions of Section 15A(b)(8) of the Securities Exchange Act on the exercise of the Association's authority and responsibilities under Section 15A(b)(12) of the Act. As you know, under paragraph (8), the rules of the Association are required to be designed, among other things, "to remove impediments to and perfect the mechanism of a free and open market" and that they not be designed "to permit unfair discrimination between customers or issuers, or brokers or dealers . . .

"The Commission is of the view that, under these provisions and in the light of national policies expressed in other federal statutes designed to promote free competition, any restrictions of the kind noted above should be based on some clearly defined and overriding regulatory policy contemplated by other provisions of the Act.

"The Commission therefore suggests that you discuss these questions further with the Division in the near future with a view to your preparing a full written presentation exploring these questions and making appropriate recommendations for consideration by the Commission."¹⁴

In subsequent discussions, the NASD representatives advised the Division that it believed it would have serious difficulties in obtaining the membership's acceptance of the proposed system if it did not specifically indicate to the membership that it planned to exclude third market securities from the system. The NASD therefore advised the Division that it could not agree to the Division's suggestions of eliminating such language from the early drafts of its brochure to be sent to members interested in subscribing to the system.

At its May, 1968 meeting, the Board of Governors of the NASD lent its full support to the position of the Automation Committee before the SEC. The Board felt that the entry of third market securities was inappropriate to the system because it felt NASDAQ was designed primarily to facilitate quotations and distribution of over-the-counter securities. In addition, the Board felt the NASD could not expect Exchange member firms to participate in a system that promoted competition from the third market.¹⁵

At the same time, the NASD prepared another draft of the brochure to be sent to its members, explaining how NASDAQ would operate. The draft still indicated that third market securities would not be included. As a result, on May 14, Pollack wrote the NASD:

"The Commission has instructed me to advise you that, in its opinion, it would be inappropriate for the Association to represent to its membership at this time that the various proposed restrictions on access to the system referred to in my letter of April 10, 1968 were or are likely to be adopted."¹⁶

On May 28, the Commission was advised that the NASD had agreed to amend its brochure to concur with Pollack's suggestions.

Through the mechanism of "prefiling" draft rules, the NASD and the staff of the SEC sought to resolve in advance any areas of disagreement on the proposed NASDAQ rules and thus ensure SEC non-disapproval of such changes when they were filed for formal Commission action as required under Section 15A(j). Accordingly, beginning in July, 1968, the NASD submitted to the Division staff various draft rule proposals for establishment and regulation of the NASDAQ system. The proposals contained a prohibition against the quotation

¹³ Official minutes, Securities and Exchange Commission meeting of Mar. 20, 1968.

¹⁴ Letter from Irving M. Pollack, Director, SEC Division of Trading and Markets to Richard Walbert, president of the NASD, Apr. 10, 1968.

¹⁵ Official record of meeting of the NASD Board of Governors, May 1968.

¹⁶ Letter from Irving M. Pollack, Director, SEC Division of Trading and Markets to Richard Walbert, president, NASD, May 14, 1968.

of any security listed on the NYSE or AMEX, and were accompanied by a written justification, as follows:

"A. The NASDAQ system is being established for the purpose of providing readily accessible quotations data on securities which have no available facilities for such service. Securities traded or listed on the New York Stock Exchange and the American Stock Exchange are well served by existing, competitive communications systems.

"B. It appears unlikely that any OTC broker or dealer would seek NASD approval to enter quotes in the NASDAQ system for listed securities. At the present time, third market quotations are based on actual transactions on the NYSE as reported on the ticker. The third market quotations are altered, as needed, to track the NYSE transactions. As a consequence, quotations may be changed very quickly. Were third market securities quotations entered on the NASDAQ system, a registered representative would have little assurance that he could effect a transaction in the third market at the representative price appearing in the NASDAQ system. Such quotations could not be called "fair and informative." Rather they would be "misleading." NASD rules permitting such a condition to exist would not meet the requirements of subsection 15A(b) (12) of the Act.

"C. Data as to actual transactions on the NYSE are now available through tickers and electronic systems throughout the country. This apparently provides adequate intelligence for formulating quotations and negotiating transactions in listed securities being traded on the OTC market.

"D. The Arthur D. Little market survey indicates that if NASD were to announce in advance that the NASDAQ system would carry quotations in third market securities, members needed to make the system economically feasible would be discouraged from subscribing. The reasons are readily apparent.

"1. Third market securities are listed on the New York Stock Exchange and American Stock Exchange. Members of these two Exchanges provide the backbone of the market for Level 2 service. Exchange rules restrict their activities in the third market.

"2. Exchange members cannot be expected to deliberately bring into being a quotations system which might undo the efforts of the Exchanges to achieve a viable market, with depth, in listed securities, without their financial support as subscribers, it is unlikely that the NASDAQ system would ever become operational.

"3. If we delete from consideration the NYSE-ASE firms, the remaining NASD members that theoretically could have an interest in obtaining third market quotations simply could not support the economics of the NASDAQ system. Approximately 2,200 of these firms are primarily mutual fund distributors and not interested in obtaining quotations from the NASDAQ system.¹⁷

In reviewing the NASD's submission, the Division took the position that it was not necessary for the question of eligibility of listed securities for inclusion in NASDAQ to be decided at that time. It pointed out to the Commission that, according to the NASD, no interest had yet been expressed by market makers in quoting such securities in NASDAQ, and that the Association had decided to commence operation with only the National List securities.¹⁸ The Division anticipated that with their limited list of securities the NASD would gain experience and "work out the bugs" in the initial stages prior to expanding the list of authorized securities. However, the Division did express its belief that if the Commission were to answer the question of inclusion of third market securities at that time, their answer should be to deny approval of the proposed restrictions on listed securities.

On September 9, the Commission agreed that the issue did not have to be decided at that time. It also concurred with the Division's recommendation that the specific restriction prohibiting listed securities be deleted. This recommendation was communicated orally to the NASD staff about September 11, 1970. The NASD Automation Committee, concerned that the SEC might disapprove its NASDAQ rules, agreed to delete the restriction on listed securities.

¹⁷ Memorandum of access to the NASDAQ system prepared for the NASD, Aug. 22, 1968 at 21-23.

¹⁸ The National List is a compilation of 1,500 unlisted securities, published daily by the NASD and circulated nationwide to all major newspapers. The NASD requires that each issue on this list have at least: (1) 3,000 shareholders, (2) 3 marketmakers, (3) 100,000 shares outstanding in public hands, and (4) a minimum market value of \$5 per share.

On November 11, 1968, an explanatory memorandum and official ballot concerning the NASDAQ rule and by-law changes were circulated to the entire NASD membership. The membership was asked to vote on the addition of a new, general by-law and not specifically on the standards for inclusion in the system, which were to be the responsibility of the Board of Governors. The ballot was accompanied by a draft of Schedule D containing "the actual procedures which will be essential for the functioning of the NASDAQ system."¹⁹ The memorandum stated:

"It is contemplated that the Board of Governors will adopt the Schedule D in substantially the form attached shortly after the vote of membership which approves the new by-laws and by-law amendments. Article XVI will empower the Board of Governors to amend Schedule D as may become necessary or desirable from time to time."²⁰

The only specific reference in Schedule D to the eligibility of third market securities was the sentence: "Every security on the Corporation's approval National Daily List on the day the system commences operation should be deemed an authorized security."²¹ However, the accompanying memorandum contained the following passage explaining the ramifications of this language.

"The NASDAQ System has been developed to provide an automated quotations system for securities traded over-the-counter. If an application were received on a security which is also listed on a stock exchange and there were an active, over-the-counter market for the security, it would be necessary to consider whether under the circumstances the security meets established standards for inclusion in the system."²²

Thus the membership was asked to authorize the bylaws on the basis that listed stocks could at least be considered for inclusion.

These changes were formally submitted by the Board of Governors to the Commission on December 12, 1968 for the Commission's review under Section 15A(j) of the Exchange Act.²³ On January 8, 1969 the Commission issued a letter of non-disapproval of these NASDAQ bylaws.²⁴

In September 1969, the NASD staff advised the Division of Trading and Markets that in order to promote subscriptions by members of the NASDAQ system, the Automation Committee had decided to substantially lower the listing standards to permit the inclusion of 1,500 additional securities. As a result, in early October 1969, a draft NASD proposal, revising the NASDAQ listing standards previously approved by the SEC in January 1969, was submitted to the Division for informal comment. The SEC staff, in turn, advised the Automation Committee that, since the NASD now intended to include securities not on the National List, the staff could not see how the NASD could fail to include listed securities otherwise meeting the NASD standards relating to the number of market makers, the number of shareholders, assets, net worth, etc. After several months of discussion with the Division staff, substantial revisions were made in the proposed rules for eligible securities and they were again submitted to the Division for informal comment in February 1970. These new proposals included a specific provision authorizing the quotation on NASDAQ of securities listed on all national and regional exchanges.

The revised securities eligibility requirements were approved by the Board of Governors at its May, 1970 meeting and formally filed for review with the Commission on June 4.²⁵ The Commission issued its official letter of non-disapproval on June 26, 1970.²⁶

The NASD had now moved from its position prior to September 1968 of specifically excluding listed securities to a position in November 1968 of at least considering their quotation if such securities met certain specified standards for listing, volume, and sufficient market makers and finally to a position in May of

¹⁹ Memorandum from Phil E. Pearce, chairman, NASD Board of Governors to members of the NASD, Nov. 11, 1968 at 3.

²⁰ Id. at 3.

²¹ Id., proposed amendments to the bylaws, schedule D at 10.

²² Id. at 3.

²³ Letter from Gordon S. Macklin, Jr., president, NASD to Ernest L. Dessecker, records and service officer, SEC, Dec. 12, 1968.

²⁴ Letter from Irving M. Pollack, director, Division of Trading and Markets to Gordon E. Macklin, Jr., president of the NASD, Jan. 8, 1969.

²⁵ Letter from Gordon S. Macklin, Jr., president, NASD to Orval L. DuBois, Secretary, SEC, June 4, 1970.

²⁶ Letter from Irving M. Pollack, Director, SEC Division of Trading and Markets to Gordon S. Macklin, Jr., president, NASD, June 26, 1970.

1970 of adopting rules specifically permitting the inclusion of quotations of listed securities.

However, at a meeting on August 26, 1970, the NASDAQ Committee again considered the possibility of excluding listed securities. The Committee decided to leave the question in the hands of the President and Chairman to work out in light of the preference of a majority of the Committee to exclude listed securities at start-up.²⁷

On October 9, 1970, Ralph Saul, President of the American Stock Exchange, wrote a detailed letter to the SEC urging that the decision to include listed securities in NASDAQ be reconsidered. Citing the overriding impact that inclusion of exchange listed stocks could have on the established exchanges, Saul urged that the SEC hold thorough hearings on the subject before it permitted the NASD to include listed securities on its automated system. He pointed out that:

"... interested parties have not been provided with information concerning the basis for this decision nor been given an opportunity to meet nor indicate the manner in which other securities markets and the investigating public might be affected ... all interested parties are entitled to know what criteria have been applied in reaching a decision to include listed securities and to have a public discussion of the reasons."

He further stated that:

"... over the past two years the important problems that have been dealt with by the Commission ... have not been treated in a routine manner. Proposals relating to commission rates, access, give-ups and numerous other matters have properly been brought to the attention of all interested parties by public announcement and the circulation of factual material developed in connection with such matters. Opportunity has been provided to present comments and submit additional information.

"... This exchange believes that in view of the vital importance to the entire securities industry and the investing public of the decision to include listed securities in NASDAQ, (1) the Commission should require the NASD to document the factual basis for this step (2) invite comments thereon from all interested parties, and (3) based on the record thus developed, make a determination as to whether such a move is in the public interest and whether adequate procedures have been provided to protect the public. Until these steps have been taken, the rules of NASD permitting the quotation of listed securities in NASDAQ should be held in abeyance."²⁸

On October 13, Robert W. Haack, President of the NYSE, urged in a letter to the SEC that "the inclusion of listed securities in NASDAQ should be held in abeyance pending a full exploration of the possible impact of this aspect of the system on existing public markets." He also cautioned the Commission that:

"... in addition to considering whether the basic decision to include quotations on listed securities in NASDAQ meets the standards for multiple trading in listed issues as being ... necessary or appropriate in the public interest or for the protection of investors', consideration must also be given to the regulatory problems which will arise if this aspect of the automated trading is allowed to go into effect."

Haack suggested that the Commission convene a meeting of representatives of the various exchanges and the NASD to discuss how best to explore the question of including quotations of listed securities in NASDAQ.²⁹

Shortly after the exchanges' protest, Gordon Macklin, President of the NASD, and Lloyd Derrickson, Vice President and General Counsel, met with Hamer H. Budge, Chairman of the SEC, to ascertain the Commission's current attitude on a possible change in the NASD bylaws that would specifically exclude listed stocks from NASDAQ pending study of the problems that would be raised by their inclusion.

On October 22, the Executive Committee of the Board of Governors, in a telephone vote, authorized Macklin to send a letter to the SEC requesting permission to exclude listed securities from NASDAQ at start up.³⁰ On the same day, Macklin wrote Budge setting forth the Association's reasoning for wishing to exclude listed securities. Macklin pointed out that the NASD Board of Gov-

²⁷ Official minutes, NASDAQ committee meeting, Aug. 26, 1970.

²⁸ Letter from Ralph S. Saul, president, American Stock Exchange to Orval L. DuBois, Secretary, SEC, Oct. 9, 1970.

²⁹ Letter from Robert W. Haack, president, New York Stock Exchange to Hamer H. Budge, Chairman, Securities and Exchange Commission, Oct. 13, 1970.

³⁰ Official minutes, NASD Board of Governors meeting by telephone, Oct. 22, 1970.

errors "from the outset" had determined that listed securities should not be included in the NASDAQ system. He further stated that

"... It was only after lengthy conferences with the Commission staff that the Association decided to amend its proposed by-law pertaining to NASDAQ so that listed securities could be included if they meet the qualifications for authorization. This by-law was adopted in late 1968 primarily because the Board of Governors believed the Commission would disapprove it should it not include listed securities."

He recommended that "the public would be better served if it was known that the Association did not intend to entertain requests for quotations for listed securities in the system at this time." Macklin cited five basic reasons for this recommendation to the Commission.

First, the inclusion of listed stocks might add to the system's technical and operational problems at startup.

Second, the expansion of the third market might affect the viability of the exchange markets by diverting business away from them.

Third, NASDAQ could create the misleading impression that third market quotations represent a market equivalent to that of an exchange central market.

Fourth, this inclusion would divert attention from the system's primary purpose: providing current and accurate quotations for over-the-counter companies.

Fifth, the establishment of dual surveillance, volume reporting, issuer disclosure requirements, and related control techniques would be costly, confusing and disruptive to the established self-regulatory patterns.

Macklin went on to propose that:

"... experience be obtained with the operation of NASDAQ in the over-the-counter securities for which the system was designed. Our thinking is that within the next twelve months technical improvements in the system plus our experience and studies of the problems will place us in a position to make a definitive judgment as to the inclusion of listed stocks."³¹

On October 27, the Commission "approved a letter to be sent by Chairman Budge to the National Association of Securities Dealers, Inc., advising that "the Commission would have no objection if the Association does not include in the NASDAQ system at startup securities which are listed on national securities exchanges."

The Commission decided not to include in the letter an express reservation of judgment on the NASD proposal to permit a one-year delay before reaching a decision on inclusion of third market securities.³²

Beginning on October 23, the full Board of Governors was polled by telephone to ratify the changes sanctioned the day before by the Board's Executive Committee.³³ Beginning on October 27, this telephone vote was repeated using a mail ballot sent each member of the Board with a covering memorandum from Derrickson of October 23 advising in part:

"We are informed the SEC Commissioners are questioning the view that listed securities should be included in the system, and we believe that they will approve a change in Schedule D to exclude listed securities at start up."³⁴

There was also a reiteration of the Board's continuing belief that listed securities should not be included, and that their inclusion only came at the insistence of the SEC. However, there was no indication in the memorandum that any reasons had been given to the NASD for the Commissioners' new viewpoint.

On November 4, a majority of the Board of Governors voted to amend Article II of Schedule D to provide that securities listed on any national securities exchange would not be eligible at start up of the system because of the need for further study of the possible technical, operational and regulatory problems involved.³⁵ On November 5, the changes sanctioned by the Board of Governors were formally filed with the Commission for its review pursuant to the requirement of Section 15A(j) of the Securities Exchange Act.³⁶

³¹ Letter from Gordon S. Macklin, Jr., president, NASD to Hamer H. Budge, Chairman, SEC, Oct. 22, 1970.

³² Official minutes, Securities and Exchange Commission meeting of Oct. 27, 1970.

³³ Official minutes, NASD Board of Governors meeting by telephone, Oct. 23, 1970.

³⁴ Memorandum from Lloyd J. Derrickson, vice president and general counsel, NASD to members of the NASD Board of Governors, Oct. 23, 1970.

³⁵ Official minutes, NASD Board of Governors meeting by telephone, Nov. 4, 1970.

³⁶ Letter from Gordon S. Macklin, Jr., president, NASD to Ernest L. Dessecker, records and service officer, SEC, Nov. 5, 1970.

The Commission considered at its November 18th meeting whether the apparent effect of the proposed amendment was to prohibit indefinitely quotations of listed securities in the system unless or until the NASD took some affirmative action to change the amendment. However, the Commission concluded that its non-disapproval of the proposed amendments was consistent with the Commission's prior determination, arrived at in its October 27th letter to the NASD.³⁷ On November 19th, the Commission issued its formal letter of non-disapproval of the NASD rule changes.³⁸

Before the rule change became effective, Donald E. Weeden, Chairman of the Board of Weeden and Co., a leading third-market firm, challenged the NASD's action on the basis that it represented a reversal of an earlier written assurance given his firm by an NASD official in December of 1968 that third market securities would be included on NASDAQ.

Weeden stated in his letter of October 30 to the NASD that "at the time [i.e. December 1968].³⁹ I requested confirmation that no discrimination would be practiced by the NASD in making available the NASDAQ system to listed stocks which enjoy an active over-the-counter market." He further stated that he had received a prompt reply from the NASD stating that "no security will be excluded from consideration in the system because it is also listed on a stock exchange."

He then questioned the procedures followed by the NASD in changing its rules for including listed stocks. He stated that on October 23, 1970:

"... the only documents given the governors in soliciting their votes were the letters from the President of the New York Stock Exchange and the American Stock Exchange to the Commission, the President's letter to the Commission, a set of the by-laws marked up to reflect the proposed boycott, a list of third market stocks proposed for NASDAQ, and a covering memorandum expressing the belief that the Commission would approve the boycott. Interestingly enough, in their unseemly haste to get ratification of this boycott, the officers of the NASD have not waited to receive from the Commission its written views. As of this time, I am informed, the NASD still does not know officially the Commission's position. Absent that written statement of the Commission's policy, I question the propriety of the officers of the NASD soliciting the Governors in this important matter on the basis of their guess of what the Commission will or will not do."

Weeden went on to point out the action he took to attempt to overcome this decision.

"On October 27, 1970, I met with Messrs. Teach, Macklin and Derrickson of the NASD and asked them to reconsider this ill-conceived, and in my view, illegal boycott. My request was refused. The same day I met with the Chairman of the Commission and expressed my dismay at this abrupt, apparent approval by the Commission of a boycott of third market securities. Judge Budge informed me that in his opinion this was not a reversal of position by the Commission since the comments previously expressed against any boycott of third market securities were those of the staff of the Commission and not the Commissioners."

He also requested in part that the NASD accede to the following:

"1. A meeting of the Board of Governors be called to permit full discussion of the proposed amendment to Schedule D eliminating third market securities from NASDAQ, and that pending such meeting, the President be instructed to take no further action to implement the exclusion of third market securities.

"2. A memorandum be prepared by the officers of and counsel to the NASD advising the membership on the reasons for and legality of excluding third market securities and on the exclusion of third market securities from the system at this late date."⁴⁰

Gordon Teach, Chairman of the Board of the NASD, responded on November 9 that he would present Weeden's request for a meeting to the Board. At the same time, he stated that he must recommend to the Board that the request be denied "at this time" and on the basis that "no new matters have been presented for consideration" that would warrant reconsideration of a decision that was overwhelmingly endorsed by the Board. He also stated that he would present to the Executive Committee of the Board Weeden's request for a memorandum

³⁷ Official minutes, Securities and Exchange Commission meeting of Oct. 27, 1970.

³⁸ Letter from Irving M. Pollack to Gordon S. Macklin, Jr., Nov. 19, 1970.

³⁹ Letter from John H. Hodges, Jr., director, automated quotations, NASD to Donald E. Weeden, chairman of the board, Weeden & Co., Inc., Dec. 23, 1968.

⁴⁰ Letter from Donald E. Weeden, chairman of the board, Weeden & Co., Inc., to the NASD board of governors, Oct. 30, 1968.

dealing with the reasons for and legality of the exclusion.⁴¹ On November 27 the Executive Committee voted by telephone to deny the request for a memorandum, but voted to send the membership and the press an explanation of the Board's actions on listed securities.⁴²

On November 17, Derrickson sent a memorandum to the members of the Board of Governors regarding Weeden's request that the Board convene a special meeting of all affected Association members to discuss the exclusion of listed securities from NASDAQ at start up. Derrickson noted Teach's opposition to such a meeting and also pointed out that the recent changes objected to so strenuously by Weeden were still pending before the Commission.⁴³ On November 30, a majority of the Board of Governors voted by mail ballot not to convene a special hearing.⁴⁴

On October 30, Weeden also sent a telegram to the SEC seeking to establish the basis for Derrickson's memorandum of October 23 to the Board of Governors advising them that the Commission would approve a change in the bylaws permitting exclusion of third market securities at start up. Weeden requested copies of all communications between the SEC and the NASD and the exchanges, staff memoranda, and Commission minutes on this matter. He went on to urge that "if Commission has not already acted consenting to such exclusion of listed securities from NASDAQ, we request an opportunity to be heard by all Commission personnel involved in the decision making process. Finally, if the Commission has already acted, we request copy of letter, or order, or minute, as the case may be setting forth such action and the reasons therefor."⁴⁵

Following the discussions between Weeden and the Commission staff concerning his request for documents, Weeden contacted the Commission again on December 15 requesting a response to his October 30 telegram. He noted that he had discussions with the staff of the NASD and the Commission:

"... who have been involved in creating the NASDAQ System and who have been concerned with its operation and regulation for the past two years. Based upon those conversations, I am satisfied that these men know of no "technical, operational or regulatory problems" involved in putting third market securities on the System. All that we have in support of this abrupt change of policy are the vagaries contained in Messrs. Saul's, Haack's and Macklin's letters to the Commission under dates of October 9, 13, and 22, respectively."

In his letter Weeden also noted his recommendation to both the Commission and the NASD for a compromise solution in which a balanced sample of 30 or 40 third market securities would be included on the system at start up, that within 6 months there would be a basis for deciding whether any of the alleged problems existed. Weeden also requested the SEC to call a public hearing prior to the start up of NASDAQ to consider this proposal.⁴⁶

On January 12, 1971, the Commission responded to Weeden's communications of October 30 and December 15. A letter from Chairman Budge advised that with respect to the request for all documents pertaining to the exclusion of listed stocks from NASDAQ, the Commission would provide many of the documents Weeden sought, primarily communications and records of discussions between the Commission and the NASD and the Exchanges. However, Budge went on to state "there are certain other materials as to which the Commission believes an exemption is applicable (under the Freedom of Information Act) and which the Commission has determined not to make publicly available."⁴⁷ These documents included memoranda from the Division to the Commission with respect to the NASDAQ System and minutes respecting the Commission's consultations with and directions to its staff. Other documents reflecting the Commission's determinations were made available to Weeden on January 12, 1971.

These protests were followed by a legal challenge from another third market firm. On December 14, 1970, Shumate and Company, a Dallas, Texas NASD firm, filed a complaint in the Federal Court in the northern district of Texas alleging that those members of the NASD Board of Governors who are associated

⁴¹ Letter from Gordon L. Teach, chairman, NASD board of governors to Donald E. Weeden, Nov. 9, 1970 at 2.

⁴² Official minutes, NASD executive committee meeting by telephone, Nov. 27, 1970.

⁴³ Memorandum from Lloyd J. Derrickson, vice president and general counsel, NASD to members of the NASD board of governors, Nov. 17, 1970.

⁴⁴ Official minutes, NASD board of governors meeting by mail, Nov. 30, 1970.

⁴⁵ Telegram from Donald E. Weeden, chairman of the board, Weeden & Co., Inc., to Orval L. DuBois, Secretary, SEC, Oct. 30, 1970.

⁴⁶ Letter from Donald E. Weeden to the Commission, Dec. 15, 1970.

⁴⁷ Letter from Hamer H. Budge, Chairman, SEC, to Donald E. Weeden, Jan. 12, 1971.

with New York Stock Exchange member firms succeeded in getting the Board of Governors to reverse the NASD's earlier decision that listed securities would be included in NASDAQ. That reversal, Shumate claimed, violated the Sherman and Clayton Acts.

Shumate alleged that, after learning of the NASD policy reversal, he talked by telephone to Macklin urging that the NASD revert to its original policy of including listed stocks. He stated that his plea was rejected, and that he then applied to become a marketmaker in two listed securities. Shumate alleged that this application was rejected on the grounds that listed securities were ineligible.

Shumate then proceeded to raise several other issues concerning the conduct of the NASD's officers and directors in excluding exchange listed stocks from NASDAQ.

First, Shumate charged that the initial telephone vote of the NASD Executive Committee, all six of whom represented NYSE member firms, constituted an arbitrary repeal of NASD bylaws that had been specifically amended in 1968 by a vote of a full membership and had already become effective under Section 15A of the Securities Exchange Act of 1934.

Second, Shumate's suit claimed that events leading up to the exclusion of listed securities from NASDAQ raised doubts about the "degree of independence" of NASD officers and whether the NASD "as presently organized under its by-laws providing for the election of its Board of Governors can ever be operated and managed apart from the economic power and underlying influence of exchange brokerage firms".

The complaint requested that the court "return management of the affairs of the NASD to members who will not discriminate and conspire against over-the-counter brokers and dealers". To accomplish this, Shumate urged the court to order a revision of NASD bylaws to provide that at least a majority of the Board of Governors be broker-dealers who are not members of either the NYSE or AMEX and that election to the Board shall be only by the full NASD membership at open annual meetings without use of district nomination committees.⁴⁸

Meanwhile, commencing in October 1970, officers of the NASD met with Weeden to discuss the problems of delay in the inclusion of listed securities. On the basis of these discussions, the NASD officers agreed to present to the Board a proposal for a test of listed securities in the NASDAQ system. On January 13, 1971, the NASDAQ Committee met and recommended the Board consider inclusion of a test group of third market securities.

At a meeting of the Executive Committee of the Board of Governors of the NASD on January 16, 1971 the discussion "included consideration of a request submitted by Weeden & Company and a proposal that test runs be made by including a control group of listed securities in the system, the time period which would be established before such test runs were made, and the impact of a pending class suit filed by Shumate & Company, Inc. and steps to be taken in connection therewith. It was the consensus that the Committee was not prepared to make any firm commitments but that the Board of Governors should be requested to give consideration to the possibility of holding open hearings to obtain the viewpoints of all interested parties."⁴⁹

After a prolonged discussion of the inclusion of listed stocks at its January 19 meeting, the Board of Governors voted to direct the Automation Committee to study the regulatory, technical, and administrative problems inherent in including listed stocks in NASDAQ, and based on this study, to "formulate a plan for a test of a controlled group of listed stocks for inclusion in the system after start up". The Board instructed the committee to report its conclusions and plan to the Board members before its next meeting in mid-March.⁵⁰

On February 8, the NASDAQ system went into operation.

On March 13, the NASD Board of Governors met again in Washington to consider the proposed test presented to it by the Automation Committee. The Board then adopted a resolution amending part II of Schedule D by adding a new paragraph to it stating:

Notwithstanding the eligibility standards set forth in part II of Schedule D, the Board of Governors may at any time and from time to time authorize use of

⁴⁸ *Shumate & Company, Inc. v. National Association of Securities Dealers, Inc.*, Civil No. CA-3-4361-C/D (N.D. Tex., filed Feb. 1, 1971).

⁴⁹ Minutes, NASD executive committee meeting, Jan. 16, 1971.

⁵⁰ Official minutes, NASD board of governors meeting, January, 1971 at 18.

the system on a test basis for whatever studies it considers necessary and appropriate."⁵¹

Pursuant to this provision the Board voted to include a controlled group of 36 exchange-listed securities in NASDAQ on a test basis for a period of 90 to 180 days beginning on April 5, 1971. The NASD stated that the test was to be undertaken in order that it might closely study possible problems before making a decision as to the permanent inclusion of listed stocks on the system.

On March 17, the Board of Governors formally filed the amendments sanctioning the limited test of third market securities with the Commission.⁵² The Commission issued its letter of non-disapproval on March 23, 1971.⁵³

Three days before the April 5 start of the NASD's third market test, Robert W. Haack, President of the New York Stock Exchange, wrote the Commission to express the Exchange's continued concern that the inclusion of listed securities in NASDAQ would create "an area of unequal regulation" that would be "inimical to the interests of investors and the concept of a central marketplace". As a result, such inclusion of listed securities had the "potential of serious and accelerated erosion of regulatory standards for listed securities."

Haack first questioned whether trades in listed securities that result from quotations on NASDAQ would be subject to the same disclosure, surveillance, and regulation that exist for trades on the Exchange. For example, he alleged that third marketmakers on NASDAQ were not required to adhere to regulation "similar or comparable" to that affecting Exchange specialists. He then noted that third marketmakers could begin or end the making of markets at any time while exchange specialists must stand ready to maintain fair and orderly markets at all times. In addition, he pointed out that while Exchange specialists are bound by rules restricting short selling, NASDAQ marketmakers are not subject to the same restraints. As a result of this uneven regulation, Haack stated his concern that steps must be taken to prevent transactions in listed securities through NASDAQ from eroding the effectiveness of trading halts and other measures that inhibit excessive speculation.⁵⁴

Ralph Saul, President of the American Stock Exchange, wrote to the Commission on April 5, reiterating his previous objection to the inclusion of listed securities and urging that the SEC "hold a public hearing for the purpose of establishing a sound factual basis for its determinations" in the approval of the NASD's third market test.⁵⁵

On June 5, Chairman William J. Casey, on behalf of the Commission, sent an identical response to both Haack and Saul. He stated that "we have discussed the many possible, legal, structural, and economic implications of the inclusion of listed securities in the NASDAQ system and found that it is too early to arrive at any hard conclusions. As a result, the Commission has approved the limited and temporary third market study with the consideration that "the Association will specifically consider during the course of its study many of the regulatory questions you raise in your correspondence of this matter."⁵⁶

The NASD Board of Governors met on September 21, 1971 to review the results of the first 5 months of its third market study. On the basis of these results, the Automation Committee recommended that the test period be extended to January 15, 1972 and that the system begin listing all third market securities which have two marketmakers and would otherwise qualify. The Committee's recommendation was approved by the Board.⁵⁷

It was also agreed by the Board that although the third market test would end on January 15, the securities included in that test would continue to be listed in the system pending completion of the analysis of the data and conclusions obtained from its study.

The amendments to Schedule D filed by the NASD in March 1971 sanctioning the planned third market test provided the Association with broad authority in conducting its study. Expansion of the study, therefore, did not require the Com-

⁵¹ Resolution of the NASD board of governors dated Mar. 13, 1971.

⁵² Letter from Gordon S. Macklin, Jr., president, NASD to Ernest L. Dessecker, records and service officer, SEC, March 17, 1971.

⁵³ Letter of Irving M. Pollack, Director, SEC Division of Trading and Markets to Gordon S. Macklin, Jr., president, NASD, Mar. 23, 1971.

⁵⁴ Letter from Robert W. Haack, president, New York Stock Exchange to the Commission, Apr. 2, 1971.

⁵⁵ Letter from Ralph S. Saul, president, American Stock Exchange to the Commission, Apr. 5, 1971.

⁵⁶ Letters from William J. Casey, Chairman, SEC to Robert W. Haack and Ralph S. Saul, June 7, 1971.

⁵⁷ Official minutes, NASD board of governors meeting, September 1971 at 12.

mission to make a formal finding of non-disapproval under Section 15A(j). As a result, the NASD expanded its experiment with listed securities by authorizing inclusion of any listed issue in which two firms registered as marketmakers providing the issue met all other NASDQ qualifications.⁵⁸

On April 28, 1972, the NASD published a 44-page report setting forth the findings of its study. The NASD stated that its evaluation had two primary objectives:

"first, a determination of the characteristics, size and significance of the "third market," i.e. over-the-counter trading of listed securities; and second, analysis of changes which may have occurred as a result of including exchange-listed issues in the NASD automated quotation system."⁵⁹

The study thus concluded that:

"The findings in response to the first objective seem clear. The third market is growing in importance. Third market makers who do any significant amount of principal trading are well capitalized. Issues traded in this market are primarily of institutional interest. Investors able to deal directly with third market makers realize significant savings over the cost of executing trades on exchanges. Non-exchange member broker-dealers are able to provide order executions at prices competitive with prevailing exchange prices, and retain most of the minimum commission charge when dealing with third market makers on an agency basis for retail customers. The new NYSE minimum commission rates are not likely to have a significant effect on the over-the-counter proportion of trades in the exchange-listed issues.

"As to the second objective, no deleterious effects on the general market structure have been observed following inclusion of exchange-listed issues in NASDAQ. The NASDAQ third market makers handle blocks with no more disturbance to prices, and sometimes less, than occurs in the NYSE. Less than 10 percent of large trades (5,000 shares or more) by market makers are executed on exchanges. Short sales by customers to market makers are minimal. Short sales by market makers on regional exchanges represent about the same proportion of total transactions as in the over-the-counter market. And, short sales by the third market makers are generally at a price above the last price on the primary exchange. The willingness of third market makers to sell short in response to buy orders contributes to the stability of the market by offsetting balances between the arrival of buy and sell orders. No short sales were effected by market makers on the primary exchange for the NASDAQ included issues.

"Moreover, the high degree of competition between NASDAQ and exchange quotations has had a small but significant effect in reducing dealer spreads for issues included in NASDAQ."⁶⁰

On May 9, the Board of Governors unanimously voted to include Exchange-listed securities in NASDAQ on a permanent basis.⁶¹

On July 7, the NASD filed for formal Commission review its amendments providing for the permanent inclusion of listed stocks. As part of this filing, the NASD advised the Commission:

"Just prior to the beginning of system operation we expressed some concern over the potential technical and regulatory impact of including listed securities in the System. However, after collecting the data for one year in listed securities quoted on a test basis and also having had a year of operating experience with the System, it was the opinion of the Association that these potential difficulties have been overcome."⁶²

ISSUES AND QUESTIONS

The decision on the inclusion of listed stocks in NASDAQ had important ramifications for the future of the securities industry. Under the Securities Exchange Act of 1934, the decision was to be made by the NASD, subject to a power of disapproval by the SEC. Yet the history of the decision-making process indicates that neither of the agencies involved had a clear idea of what factors should be taken into account and what procedures should be followed to arrive at a sensible and fair result.

⁵⁸ *Id.* at 12.

⁵⁹ The NASDAQ—third market study, NASD, Apr. 28, 1971 at foreword.

⁶⁰ *Id.* at 1.

⁶¹ Official minutes, NASD board of governors meeting, May, 1972 at 12.

⁶² Letter from Gordon S. Macklin, Jr., president, NASD to Ernest L. Dessecker, records and service officer, SEC, July 7, 1972.

SCOPE OF SELF-REGULATORY RESPONSIBILITY

One question is whether a decision of this nature was one which the NASD was equipped to make. The NASD's principal job is regulation of the activities of its members. By law it must be open to all qualified broker-dealers. In NASDAQ, it was for the first time engaging in the operation of a market information system that was to some extent competitive with the market information systems operated by stock exchanges. The NASD membership included firms whose principal activity is in the exchange markets as well as firms who deal exclusively in the over-the-counter market.

Are self-regulatory organizations in a position to reach fair and constructive decisions on questions which involve largely economic issues between different classes of members, or between members and non-members?

Should the NASD "promote" the interests of the over-the-counter market in competition with exchange markets, in the same manner as the exchanges "promote" the interests of their markets?

If so, to what extent should firms whose principal economic attachment is to the exchange markets be permitted to participate in decisions involving inter-market competition?

SELF-REGULATORY DECISIONMAKING

Assuming that the NASD was the appropriate body to make the initial decision, there is a question whether the procedures it followed were fair to all interested parties. The memorandum sent to NASD members in November 1968 to solicit their approval of the NASDAQ system indicated that listed securities would be considered for inclusion if they met "established standards." One third market firm stated that it had received written assurance from an NASD official that they would be included.

Should the decision on inclusion of listed securities have been submitted to the full NASD membership or decided by the Board of Governors?

Did the membership vote on the by-law changes, in light of the language in the attached memorandum, constitute a membership decision in favor of inclusion?

Should the decision have been subject to reversal by the Board of Governors of the NASD without a resolicitation of the membership and an opportunity for public comment?

COMMISSION PROCEDURE FOR REVIEWING NASD RULEMAKING

The SEC's action in 1968-70, first preventing the NASD from excluding listed securities, and then acquiescing in such exclusion, were products of the "informal bargaining process" which has generally characterized the SEC's relationship with the self-regulatory agencies. Not only was there no public hearing, but at no point during the entire period was a public statement made that the Commission had made a decision on the issue—much less what the decision was, when it was made, and what it was based on. The staff, in its communications with the NASD, repeatedly referred to positions as those of the "Commission." However, a new Chairman in 1970, who had been a member of the Commission throughout the period, was reported to have said that it was only the staff that had opposed the NASD's proposal to exclude listed securities.

In view of the controversy over the subject, should the SEC have conducted a formal proceeding before reaching a decision in 1968?

Whether the 1968 position was in fact only a staff position, or reflected a Commission decision, should the SEC have conducted a formal proceeding before reversing that position in 1970?

Does the confusion over what the SEC had or had not done indicate the need for more "formal" procedures in passing on questions of this nature?

The strongest proponents and strongest opponents of inclusion of listed securities were equally vehement in calling for a full public consideration of the issues involved.

Would a full public hearing likely have produced a prompt and more orderly decision in favor of the test by which the questions were ultimately answered? Might it have produced a decision against the conduct of such a test?

Which side should have had the "burden of proof" in any public proceeding on this question? Should the proponents of inclusion of listed securities have been required to provide affirmative justification for their position to overcome concern about adverse changes that might result? Could they do so? Or should

the opponents have been required to present evidence of specific dangers to overcome the concern about the anti-competitive impact of their position? Could they do so?

ARTICULATION OF REGULATORY POLICY FINDINGS BY NASD AND SEC

In its final reports on the results of its test of listed securities in NASDAQ, the NASD found "no deleterious effects" and approved, apparently without serious controversy, the permanent inclusion of listed securities in the system. Yet, as late as October 1971, the position of the NASD Board, acquiesced in by the SEC, was that listed securities should not be included in NASDAQ. The ultimate conclusion indicates that the concerns which led to the earlier decision may not have been warranted.

To what extent did the emphasis on negative aspects of the inclusion of listed securities result from the absence of public input on the merits of the issue, or the influence of groups opposed to such inclusion? (In other words, would the decision likely have been different if there had been a full public hearing on the subject?)

What were the principal factors that led the NASD Board to change its position in early 1971 to favor a prompt test of listed securities?

Is there any rational procedure by which speculative regulatory problems can be weighed against speculative consequences of restraint on competition? Should there be a general presumption for, or against, competition in the decision-making process of the SEC and the self-regulatory organizations?

Is it likely that the NASD Board would have reached its earlier position on the exclusion of listed securities if it had been required to state publicly the reasons for its decision and the regulatory needs which justified the competitive restraint?

ADEQUACY OF PROCEDURES FOR CONSIDERATION OF ANTITRUST LEGISLATION OF SELF-REGULATORY RULEMAKING

The issue of inclusion of listed securities had significant competitive implications. The SEC opposition to the NASD's original attempt at exclusion was apparently based largely on competitive considerations. The new position taken by the SEC in October-November 1970, however, was adopted without any recorded reference to consideration of antitrust questions. The subsequent agreement by the NASD Board to a test of listed securities in NASDAQ followed the bringing of a private antitrust suit against the NASD by one brokerage firm and a threat of such action by third-market makers. At no time was the Department of Justice consulted with respect to the anti-competitive aspects of the proposed exclusion of listed securities.

Should more formalized procedures be developed for considering the antitrust questions involved in a decision of this type? Who should participate in those procedures, and on what basis?

Did the availability of private relief under the antitrust law have a significant effect on the final resolution? Was it a constructive effect?

Senator WILLIAMS. I personally believe this kind of detailed objective recitation of the facts exemplified by this case study gives the Subcommittee and the public a clearer view of how the regulatory process system is currently operating and where its principal weaknesses lie.

Our witnesses today are representatives of the two agencies which are responsible for the decisions on this question. From the Securities and Exchange Commission. Commissioner Philip A. Loomis, Jr., who has been a member of the Commission since August 13, 1971 and was general counsel of the Commission during most of the period covered by this study is one of our witnesses.

Representing the National Association of Securities Dealers, Gordon S. Macklin, president, and Lloyd Derrickson, senior vice president and general counsel.

I know you have been furnished with copies of the case study, including a statement of the issues, and I know that you were given an

opportunity to review a draft of this study to be sure that it was an accurate statement and report of what took place.

I certainly appreciate your cooperation with the subcommittee in this matter and of course in matters prior to this. You have been very helpful in furnishing so much of the information on which the study is based.

Our purpose this afternoon is not to criticize anybody or to fix responsibility for any deficiencies in past performance, but to see how we can improve the system for the future.

Basically we want your help in reconstructing the process by which these decisions were made as well as your views as to what changes in the law possibly are desirable to improve that process.

In addition to receiving your testimony this afternoon, we plan to send copies of the case study to other people who had an interest in these decisions, as well as send it to disinterested observers of the administrative process and get their views on questions raised by the case study.

Let us begin.

Commissioner Loomis, you seem poised and ready to go.

STATEMENT OF PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. Loomis. I hope so.

First I want to thank the committee and its staff for furnishing us a copy of the case study and of prior drafts so we could understand the issues that are to be raised, and I think an excellent job was done by the staff, while this doesn't mean that we necessarily agree in every respect with every interpretation of the circumstances.

I have a prepared statement which is not directed particularly to this or any other case study, but to the general issue which is being explored by means of these studies. I would like to read parts of it, at least, and submit it for the record.

Senator WILLIAMS. Fine.

Mr. Loomis. Mr. Chairman :

As part of your committee's overall examination of the securities markets and their evolution and regulation, you are interested, and properly so, in the decisionmaking processes used by the self-regulatory bodies and in the manner in which the Commission exercises supervision and oversight over these decisions.

The use of case studies should produce a more concrete exposition of the decisionmaking processes at work than would be likely to result from a general or theoretical discussion of that process, and I am very happy to have an opportunity to participate in what should be an illuminating analysis.

At the same time, the examples you have chosen, while very interesting, are by no means typical of the type of decisions made by the self-regulatory bodies or by the Commission, primarily because they related either to activity by a self-regulatory body which has repercussions beyond the normal scope of its activities or else relate to a matter which is to a considerable degree outside the existing pattern of the securities regulation.

At the outset I would like to comment briefly on the decisionmaking processes, both of the self-regulatory bodies and of the Commission in the exercise of oversight of their actions.

The Securities Exchange Act of 1934 says very little about the internal decisionmaking processes of the self-regulatory bodies as distinct from the substantive standards to which their decisions must conform. That act includes general principles, such as "fair administration" and "fair representation."

The general decisionmaking pattern for these bodies, which appears to have been contemplated and as it has evolved, seems to be modeled on that generally prevailing in the United States among private associations or corporations formed not to conduct business for profit, but to provide services or other benefits to their members or to the general public or both.

The pattern includes a governing board elected by the members and a staff assigned to serve the board and carry out its decisions. Structural or major decisions such as amendments to the constitution and bylaws and significant substantive rules require approval by vote of the membership.

These bodies do not act just like Government agencies, and I think this distinction is essential to the concept of self-regulation. This does not mean that the decisionmaking processes of the self-regulatory bodies cannot be improved.

There is an increasing awareness that their decisions affect persons other than their members, and that the voices of these other persons should be heard.

The self-regulatory bodies are moving in various ways to meet this need.

The NASD is increasingly exposing proposed rules for public comment, a thing they never did a few years ago, and the major exchanges and the NASD are significantly expanding public participation in their governing boards.

Further improvements will no doubt follow. I do not think, however, that the self-regulatory bodies should be saddled with the whole panoply of Government administrative procedure. I doubt if it would be suitable for a nongovernmental organization, and I know as a Government official for a good many years, and as a member of the Administrative Conference of the United States since 1968, that the field of Government administrative procedure is not without serious problems, including delay, cumbersome formalities, and unnecessary expense for all concerned.

Turning to Commission supervision or oversight, this can be exercised, as you know, in a variety of ways. Your concern, however, for purposes of the present case studies, is with Commission oversight or supervision of decisions made by the self-regulatory bodies, whether expressed in rules or otherwise.

I just wanted to point out that this type of oversight, while significant, is by no means the only type which exists and is exercised.

With respect to the rules of the self-regulatory organizations, the Commission's authority under existing law is somewhat limited. The existing statutory pattern for oversight has grown up piecemeal over the years since 1934 and contains quite a number of gaps and inconsistencies.

In May of this year, we transmitted to the Congress draft legislation which we believe will provide not only a more consistent pattern but, perhaps more importantly, would allow the Commission to exercise considerably more effective oversight with respect to rulemaking by the self-regulatory bodies, and would avoid situations where the Commission simply cannot act at all where it probably should.

One of your case studies may present this type of problem.

The deficiencies in the statutory pattern for oversight have been discussed for many years. I will not attempt to go through this background except to refer, in the light of present concern about the adequacy of Commission oversight, to the fact that when, following the Special Study, the Commission adopted rule 17a-8 requiring notice to the Commission of proposed exchange rulemaking, a distinguished member of Congress who had responsibility for oversight of the Commission suggested rather pointedly that, in his judgment, this rule was an undue and perhaps unlawful intrusion upon exchanges' rule-making processes.

We would urge that our proposed legislation, which has been introduced in the House of Representatives, be acted on promptly in order to further the continuing vigor and credibility of self-regulation by more adequate oversight.

Partly because of the lack of other procedures and partly for practical reasons, Commission oversight over the decisionmaking of the self-regulatory agencies has traditionally been carried on rather informally. This practice has been the subject of some criticism.

The criticism may in part be justified but in large measure it seems to me to be based on a misunderstanding of the nature and function of the whole process.

Some observers view the relationship between the Commission, and, for example, the New York Stock Exchange as a self-regulatory body, as being essentially the same as the relationship between a regulatory agency and a regulated company, and they seem to suggest that the Commission should proceed in much the same way as, for example, the Interstate Commerce Commission proceeds when regulating the rates of a railroad company.

This analogy is not apt. The self-regulatory agencies, acting as such, are not simply regulated companies in a regulated industry; rather, pursuant to Congressional mandate, they share with the Commission the responsibility for regulating an industry—the securities business.

Once this is appreciated, there is much to be said for the Commission's traditional informal approach which is designed to help the self-regulatory bodies do their part of the job more effectively in the public interest, rather than confronting them as adversaries in an arena.

When we discuss particular regulatory problems with the self-regulatory body, both we and they have an input of factual information and insight, and a result which reflects both their input and ours is not, as some have suggested, necessarily the product either of bargaining or of compromise. This is not to say that there is no need for improvement in the processes of our oversight.

In addition to the need for statutory changes which I have mentioned, there must be awareness of some of the unique characteristics and problems which self-regulation presents. A self-regulatory body draws its membership largely from members of the regulated industry.

This is a source of strength insofar as they bring to the regulatory task practical business judgment and experience which can hardly be duplicated in a government agency.

But it also creates problems insofar as self-regulatory decisions may be influenced by a desire to promote the economic interest of members or of a particular group of members or by a wish to preserve or obtain a competitive advantage.

Oversight should not only insure but also appear to insure that regulatory decisions are not made for other than regulatory purposes.

Procedures for Commission oversight of self-regulatory action require a balancing between the opportunity for frank and uninhibited discussion of policy issues and the need to give all persons, whether members or not, who may be affected by the action, a chance to make their views known.

In response to this, the Commission has increasingly in recent years developed procedures for public participation in this process. We have held extensive public hearings on such significant questions as exchange commission rates, institutional membership and the future structure of the securities markets.

Following the latest set of hearings, the Commission issued its statement on the future structure of the securities markets in which it articulated its general conclusions and approach, based upon the record thus made, to a number of major questions and also pointed out directions in which it believed the securities industry must move.

Procedures must be accommodated to their purposes. Thus we believe that, where the self-regulatory bodies or the Commission or both are engaged in formulating policy or establishing rules or standards for future conduct, the function and therefore the appropriate procedure is of a quasi-legislative nature and should resemble the fact-finding and deliberative practice of a legislative body, rather than the trial of a lawsuit.

Last week we issued a notice of proposed rulemaking with respect to membership on registered securities exchanges, for other than public purposes, in which we outlined the procedures to be followed in that proceeding and the reasons for their selection. These procedures are basically quasi-legislative.

This is a period of rapid change in the securities markets in which difficult policy decisions have to be made. Procedures for decision-making must also change, but I do not think they should be confined within rigid molds. There is still a need for experimentation to find the procedures best suited to the tasks and decisions before us.

Thank you, Mr. Chairman.

Senator WILLIAMS. Fine, thank you, very much, Commissioner Loomis.

Before we get into a general discussion, let us have your formal statement, Mr. Macklin.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. MACKLIN. Thank you, Mr. Chairman.

We have submitted an 11-page written statement commenting on your staff study and I have a short summary of that statement to read now.

Senator WILLIAMS. Even though you submitted this statement in advance as we had hoped you would under the rules, I frankly have not had a chance to read it, so if there is anything that is important for our later discussions, don't overlook it in your summary.

Mr. MACKLIN. All right, fine. I think I have most of the highlights in the shorter statement.

We welcome this opportunity to appear today to discuss the inclusion of listed stocks in the NASDAQ system. We believe your staff study was well done and provides a good factual background for this discussion. We feel the time spent here this afternoon will be worthwhile and will demonstrate to you that the process through which our board arrived at the decision to include listed stocks of NASDAQ was sincere and comprehensive.

We believe a number of key points are apparent from your staff study and our prepared answer. One, that both sides of the question of whether or not to include listed securities in the NASDAQ system were charged with an emotionalism far beyond the economic significance of the question itself.

Two, prior to startup, neither the NASD nor the Commission was in possession of enough facts to make a considered judgment as to the impact of including listed stocks in the NASDAQ system.

Three, the need for the NASDAQ system was particularly acute for those dealers handling over-the-counter securities where there was not a national system for transmitting current market information.

Four, prior to the startup of the NASDAQ system, we had received applications to include about 2,300 securities. Of these, less than 1.7 percent were exchange-listed securities traded by third-market dealers. Even today, after the NASDAQ system has been available for all exchange-listed securities which meet our system's requirements since October of 1971, these issues represent only 2.7 percent of all issues in the system. Only 8 percent of the total marketmakers in the NASDAQ system deal in exchange-listed securities and third-market trading in the system is usually less than 4 percent of the total daily NASDAQ buying.

And five, in October 1970, we were under very intensive pressure to start the system promptly, not only to accommodate our members anxiously awaiting startup, but also to recognize that Bunker-Ramo had invested about \$25 million and was naturally eager to start receiving revenue to support this investment as quickly as possible.

The sum total of all these factors led our board to the decision that it was preferable to start the system first and analyze the possible problems connected with listed securities in this system after startup. It was never our intent to defer decision for many years into the future.

Within 2 months after startup, we did implement a test of third-market securities in the NASDAQ system which was subsequently expanded in the fall to include all third-market securities. Rather than conduct a series of hearings, we participated in and closely monitored the hearings held by the SEC.

Primarily as the result of our tests, the SEC Institutional Investors Study, which was released in March of 1971, and the SEC hearings, the final decision reached by our board of governors was built on a factual basis.

Some of the problems that were originally raised are still with us, such as the difference in regulation between exchange markets and the

over-the-counter market. With this in mind, our board of governors has appointed a committee on third-market rules and disclosure which is now addressing and reviewing regulatory problems in this area.

Although, as you gentlemen know better than I, you can never please everyone, I believe you will find that most of the major participants in the third market will testify to the fact that we are a conscientious organization which conducts itself in a responsible manner.

STATEMENT OF A PANEL OF WITNESSES REPRESENTING SEC AND NASD

Senator WILLIAMS. Thank you, very much, Mr. Macklin.

If there are no further opening statements, we will now proceed to the questions on this case.

The decision on the inclusion of listed stocks in NASDAQ obviously had important ramifications for the future of the securities industry. Under the Exchange Act of 1934, the decision was to be made by the NASD with the SEC having the power of disapproval.

Is that an accurate statement, Mr. Commissioner?

Mr. LOOMIS. Yes.

Senator WILLIAMS. Going through the case study, it does not appear to me that either agency had a clear idea of what factors they should take into account and what procedures they should follow.

One question is whether the NASD should be called on to make a decision of this nature. The association's principal job is regulation of the activities of its members. By law, it must be open to all qualified broker-dealers.

In NASDAQ it was for the first time operating its own market information system that was to some extent competitive with the stock exchanges. The NASD membership included firms whose principal activity is in the exchange markets as well as firms who deal exclusively in the over-the-counter market.

Is the NASD in a position to reach a fair decision on questions which involve largely economic issues between different classes of its members? This seems to me just a fundamental first observation or question to get into our discussion here.

How does the Commission view that?

Mr. LOOMIS. Well, I think that this is an inherent problem of self-regulation, as I have pointed out in my introductory statement. Self-regulatory bodies are necessarily drawn from the industry and their economic interests may not all be identical.

But nevertheless, if we are to have self-regulation, and I think it should not be abolished, the self-regulatory agencies have to accommodate themselves to the fact that there are different economic interests which will be affected by their decisions, and they have to try to accommodate those different interests. So if I may say so, with all respect, a legislative body has to accommodate the varying economic interests of its constituents.

I think that they do a reasonably good job of it. They have been doing it for years, all of the self-regulatory bodies of any importance.

It is a purpose of our oversight to make sure they do not do it wrong. The courts are also there, if necessary. As I have also pointed out in my statement, I think that oversight should be particularly and perhaps more so than it has at times been in the past, directed to this problem.

I would like to just say briefly for a minute or two that some of the assumptions here in the framing of the question raise some problems. The basic genesis of NASDAQ was the decision on the part of the Congress, upon recommendation of the Commission and the Special Study concurred in by the NASD, that the system of quotations in the over-the-counter market as it had theretofore existed was obsolete and unsatisfactory, and in fact it had been for years, and we had been worried about that.

The only way to remedy this that seemed readily available was to make use of modern data processing technology. The NASD faced up to this responsibility, created a vastly improved system for market disclosure and quotations in the over-the-counter market.

The responsibility for doing so had been placed on it by the Congress, and it did it. I do not think that there is anyone else who should have been given the job. NASDAQ is simply the application of modern technology to a job which the NASD had been attempting to do without the benefit of that technology for many years, with as much success as might reasonably be expected under those circumstances, and by those methods.

And what we have here, and we should not lose sight of it, is a major achievement which has been completed, given its size and complexity, in a very short time, and it is of major value to the investing public, particularly insofar as over-the-counter securities are concerned, as to which there was previously a regrettable lack of disclosure of market information.

Senator WILLIAMS. Do you want to comment on that question, Mr. Macklin?

Mr. MACKLIN. Well, you know, any thoughts I have are going to be highly biased so I suppose you should have a common denominator for any opinions we put out, but I think a good bit of what Commissioner Loomis said is very true, and as it relates to the functioning of the NASD in economic matters, the whole development of the NASDAQ system is certainly some tribute to the fact that our organization does function well.

We could relate an equally long and important story related to the development of our National Clearing Corporation, which again has strong economic overtones and which I think you would be pleased with the effort of our organization.

I think that our experience has shown that the responsibilities that our association has inspires a fiduciary type of conduct among our directors and governors that is like nothing I have ever seen in 20 years of business life. I think the directors have the public interest and a broad gage interest at the meetings, but as Commissioner Loomis said, even if they didn't, the direct oversight of the Commission and the eventual access to the courts certainly gives plenty of protection against our making unfair and arbitrary decisions.

Senator WILLIAMS. From where you sat, you had competing forces sitting in decision on this NASDAQ question. You have the exchange members as members of your association.

Their economic interests were contrary to those who were purely members of your NASD without any exchange membership, so you had competing forces sitting within your association.

How did you approach this? What procedures did you use?

The record suggests to me that it wasn't thrashed out at your level or at the SEC level in any forum-like situation of public discussion in order to arrive at a decision that was directed at the public interest.

Mr. MACKLIN. Not until the advanced stages, at least. Of course what the record doesn't show is that I wasn't even on the job at the NASD until some time in 1970, so that it is conceivable that a change of officials and my lack of experience might have made the ties to the past even more difficult.

But the record, in my opinion, shows that a good bit of the discussions were built around so-called antitrust judgments of various people looking in on this matter and very little real factual addressing to the actual problems that were raised by both sides, both sides arguing both in favor of listing and not including them.

And I think the course of action which included an actual test of these securities, a monitoring of tests of those trading patterns, and open, public hearings, which I think the Commission did a superb job in conducting was eventually the right way to bring out enough facts to solve it on a rational basis.

Senator WILLIAMS. I missed the reference to the open hearings.

Mr. MACKLIN. I was speaking about the Commission's open hearing on market structure. It had been in our mind to have hearings ourselves to get all interested viewpoints before the Board arrived at a decision. But at the time we were developing the test and considering the hearings, why, the Commission came forth with their own hearings, which included a substantial amount of discussion on the matter of third-market trading and the future structure of markets.

Senator WILLIAMS. I don't believe our study reflects this, does it? What you said made sense, but I didn't see it reflected in the decision to include or to exclude listed securities on NASDAQ.

Mr. MACKLIN. It was certainly in our decision to include them on a permanent basis. Whether we had the hearings or the Commission had the hearings was not in our decision to temporarily delay this—

Senator WILLIAMS. Let's ask Mr. Loomis here. When was the decision made to include, and when were the market structure hearings held?

Mr. LOOMIS. It is my recollection that our market structure hearings commenced in about October 1971, and ran on through, at intervals, much of that year and ended about the end of that year.

Now it is a little difficult—you can't quite say concretely that a decision once and forever was made as to the inclusion of listed securities at any one time.

My analysis of very voluminous records at the Commission and such information as I have about the NASD indicates that the inclusion of listed securities was not regarded by any of us at that time as the foremost problem.

The foremost problem was to get this system created and operating. It seems that the basic judgment the Commission made was that it didn't have to make a judgment as to whether listed securities should be included or not.

Senator WILLIAMS. Would you repeat that again, please?

Mr. LOOMIS. The basic judgment of the Commission was that it did not have to make a final judgment as to whether listed securities

should be included in this system or not until such time as the system itself came into being.

Senator WILLIAMS. Well, now, there is where some of the ambiguity appears, because the record shows that with the color of the Commission, opinion was coming out that there should be inclusion and not exclusion. That goes right back to the beginning, doesn't it?

Mr. LOOMIS. It goes back quite a ways. At this point, just let me go a little further into that. At one point in time, the NASD was inclining to excluding. Then for various reasons they adopted an intermediate position that they would not exclude them, they would consider the possibility of their inclusion, and that was the situation at the end of 1968, as I recall.

Then later, they concluded that they would include them and then in the fall of 1970, they came to the Commission and said they would like not to include them at startup, at the beginning. The Commission's position was, as I have said, that we didn't have to make a final decision on that question before the system was designed and was operative, and we did not want to see the whole effort sidetracked into controversy over this question which would at that point be theoretical until the question really arose.

If the NASD concluded, as they had, that it would create operational and other problems to put them in at the outset, and they wanted therefore to start up before making that decision, we thought that was a reasonable judgment of a responsible agency to which we would not object, and then subsequently, the NASD, I think very reasonably, decided to get some practical experience with this and that was likewise acceptable to us, and that is what they have been doing.

Mr. MACKLIN. The chronology of the hearings that I was talking about starts—the system started February 8. Our third market test started April 5. In the fall the Commission announced they were going to have hearings on the structure of—future structure of the market with emphasis on the participation of the third market.

We extended our test in September of 1971. The Commission hearings, I believe, started in late October or November of 1971. Their report was issued in February of 1972, and our test concluded in January of 1972. Their report was issued in February of 1972, and our final decision was in May of 1972.

Senator WILLIAMS. It's a confusing historical record. It seems to me that at some points it appeared that the NASD was deferring to Commission opinion, and at other points the Commission was sort of deferring to the self-regulatory association.

It doesn't appear that in the process anybody clearly took responsibility for the decision.

Mr. MACKLIN. Well, during the period from startup of the system through a final decision, I think the record would show that we took the initiative in initiating the test, and, of course, when they announced their hearings, there wasn't much sense in our having a hearing.

We did participate in the SEC hearings with this statement—this is part of our statement. This is in November 1971. We said:

NASDAQ, a national communication system which is adaptable to use by all securities exchanges, already exists. Fuller use of these facilities for reporting

of the quotations and transactions of the various markets will stimulate competition which is in the public interest. We believe it is desirable to fully explore and implement the potential of NASDAQ system, including expansion of its quotations capacity and potential for trade reporting.

But there were many others that testified as to the use of NASDAQ's involvement of the third market. And I think the record of the Commission hearings was very helpful to our Board in reaching a decision. One other thing—

Senator WILLIAMS. That was when you were on the limited test?

Mr. MACKLIN. That is correct. This is in the fall of 1971.

During 1971, the Commission also released its institutional investor study, which had some excellent, we thought clearly defined statements as to their thoughts on the future direction and the benefits of exposing quotations in competing marketplaces, and that I am sure was very helpful to our Board in its deliberations.

So the Board's deliberations, after startup, included the test, the Institutional Investor Study, and the SEC hearings.

Senator WILLIAMS. The case study reflects some confusion on exactly who was speaking for the Commission—the staff or the Commission. And it appeared that the staff conclusions were expressed in terms of the Commission's views.

Mr. LOOMIS. I would like to indicate a comment on that. I have gone back through the record as thoroughly as I can. Every expression of view or of a conclusion by the staff was first cleared with the Commission.

The Commission considered every one of them. The staff did not operate on its own.

On the other hand, and this has led to some misunderstandings, there is certain hearsay in the case study to the effect that former Chairman Budge is alleged to have remarked that the comments were those of the staff, not the Commission.

I have not had a chance to talk to him about that. But looking at the record, I can see why he might have said that.

Various staff members at various points said various things, which the Commission didn't participate in, or didn't review.

But the decisions, the conclusions, the reactions were always those of the Commission.

Senator WILLIAMS. Or the Commission took the responsibility for them.

Mr. LOOMIS. No; the material—the problem was in each case submitted to the Commission before there was a response to the NASD, except where there were talks about how should you word a draft.

But anything that required any form of decision—

Senator WILLIAMS. I have to interrupt here for a vote. We will be back as soon as we can.

I will want to see if the bill, the legislation that you referred to, Commissioner, that has been introduced and is in the House, has anything to say in this area. When I come back, OK?

(Recess.)

Senator WILLIAMS. Let us resume. We had a little confusion here of what happened when. The sequence of events.

I wonder if we could go back and ask Mr. Macklin, first, when was the question clearly before you whether NASDAQ should or should

not, would or would not include listed securities? When did that first come as an issue?

Mr. MACKLIN. Before the NASD?

Senator WILLIAMS. Yes.

Mr. MACKLIN. I will refer to Mr. Derrickson, because he was there when I wasn't. When he gets to 1970, I will chime in with him.

Senator WILLIAMS. All right. We will give you 2 years' worth of recollection.

Mr. DERRICKSON. My recollection is 1968, in the summer months, when we were first preparing a brochure to distribute to members which would explain the system, the workings, the function of the various levels.

And it was brought to the attention of the Commission staff, and there was language to the effect that listed stocks would not be in the system.

That was the first time that this became an issue. And there is a letter from Mr. Pollack, as I recall—it is cited in your study—indicating—I believe the sum of it would be that the Commission did not think it wise or appropriate to decide that we should include that statement at that time. It was decided that we would just leave the statement out, and postpone any statement about it until a later date, which is what we did.

Then in late 1968, I believe our rules were voted upon by the membership and the issue had been decided that they would be included, because it was the Board's view that the Commission would not pass or would not approve these rules unless listed stocks were to be included.

Senator WILLIAMS. So the first brochure describing NASDAQ and what would be included said nothing; is that right?

Mr. DERRICKSON. The first brochure said nothing.

Senator WILLIAMS. The next communication to the members was the rule changes that would create NASDAQ, and it was stated—

Mr. DERRICKSON. The indication was that they would be included.

Mr. LOOMIS. Well, the first brochure—I just want to amplify what you said, just a trace—the first brochure dealt with a number of questions, not only the listed securities but also with the question—which was required and quite significant at the time—as to whether non-members of the NASD should be allowed to participate in the system. And if so, how.

And the views of the Commission and staff were that the NASD should not lead its members to believe that final decisions were being made on that topic.

As a result, the brochure spoke in more general language, without indicating who would be out and who would be in and what securities would be out and what securities would be in.

And then the proposal—the rules which were submitted to the membership for vote also did not specifically say whether listed securities would be in or out. They indicated that initially the system would start with the so-called national list, which was an institution that existed for a number of years of a group of over-the-counter securities for which the NASD provided the newspapers with quotations on a manual basis.

But the explanatory statement of the NASD chairman said that if someone wished to include listed securities, this matter would have to be given appropriate consideration and attention.

Mr. DERRICKSON. That is a very clear statement.

Senator WILLIAMS. Now would you restate that? Who would give it appropriate consideration?

Mr. LOOMIS. It was stated in Chairman Pearce's explanatory introduction to the proposed rules that if application was made to include a listed issue in the system, this would have to be given consideration, and a determination would have to be made as to whether it met the requirements of the system.

Senator WILLIAMS. Now, that is getting down to the real question. What were the requirements, and how did we arrive at them?

Mr. LOOMIS. There were a great many requirements evolved in a tentative fashion dealing with such things as how many shares were outstanding in public hands, was the company reporting to the Commission and providing public information, how many shareholders were there, how many market makers were interested in making a market in that security over the counter—matters of this kind.

Senator WILLIAMS. Is that addressed to listed securities?

Mr. LOOMIS. All securities, including listed securities.

Senator WILLIAMS. At one point, wasn't the word "established standards" used?

Mr. LOOMIS. At one point I believe they were, yes. In Mr. Pearce's statement, the language is "in the event application was received for a listed security, it would be necessary to consider whether under the circumstances the security meets established standards for inclusion in the system."

Senator WILLIAMS. Was the criteria for inclusion broadly stated?

Mr. LOOMIS. Yes.

Senator WILLIAMS. But it was stated that they would be considered to be included?

Mr. LOOMIS. That is what Mr. Pearce's statement said, although the proposed rule itself did not discuss the question.

Mr. MACKLIN. He was Chairman—

Mr. LOOMIS. Chairman of the Board of Governors.

Senator WILLIAMS. But that was toward the end of 1968?

Mr. MACKLIN. Yes.

Senator WILLIAMS. Here was an opportunity for listed securities to be included, stated. Was this prior to a vote on rule changes that would create the NASDAQ?

Mr. DERRICKSON. Yes; it was an explanatory memorandum that went with the rule changes so the members would understand what they were voting upon.

Senator WILLIAMS. Then they voted?

Mr. DERRICKSON. Yes.

Senator WILLIAMS. And the vote was to accept this opportunity for listed securities to be considered for inclusion on a case-by-case basis, I gather?

Mr. DERRICKSON. That would be the implication. What they really voted on was a new bylaw to regulate the NASDAQ system, and they gave the Board authority to make the decision as to the securities which would be included, without recourse to another membership vote.

Senator WILLIAMS. In other words, the bylaw submitted to them was a basic outline of the regulatory pattern, but specifically delegated to the Board the opportunity to determine such questions as what securi-

ties would be eligible and what the qualifications for eligibility would be.

Senator WILLIAMS. These bylaws and the editorial material that accompanied them were prefled with the Commission and reviewed before it went to the NASD membership?

Mr. LOOMIS. They were filed with the Commission about the time they went to the membership, as I recall.

Senator WILLIAMS. At that point, what authority did the Commission have to deal with the proposed bylaws and the informational material. Anything?

Mr. LOOMIS. At that point, legally, the matter was not before the Commission for decision. The proposed bylaws would have to be submitted to the membership and if the membership voted them and if the NASD thereupon proceeded to make them a part of its rules, the proposed rule would have to be submitted to the Commission for its approval under the act.

But this formal submission did not occur until after the membership vote.

Senator WILLIAMS. I see. But you had an informal submission? Is that provided for under the rule?

Mr. LOOMIS. No; I don't know exactly whether there was an informal submission as such. I understand the NASD gave us a copy of the papers they were sending out.

Mr. DERRICKSON. That is my recollection. I am quite sure we furnished them with a complete set of all the documents prior to the date they were sent to the membership.

Senator WILLIAMS. Not under any Commission requirement? But on your own decision?

Mr. DERRICKSON. As a measure of cooperation, in an attempt to resolve the matter and understand their position, if they had any contrary to ours.

Senator WILLIAMS. And then the membership voted on the bylaws—those proposed bylaws?

Mr. DERRICKSON. Correct.

Senator WILLIAMS. And evidently they were accepted by the membership?

Mr. DERRICKSON. Yes; they were.

Senator WILLIAMS. That was the end of 1968. Well now, after that—and I am not sure exactly when it was—but that was the end of 1968—during 1969, a decision was made to change, to withhold or not include listed securities, is that right? Or was that later in 1970?

Mr. DERRICKSON. That was in 1970, I think, Senator. If I might, I think what happened was that we had a change to be made in schedule D, dealing with the qualification for any security in the system, and this major change was price. Another change had to do with qualification, or the issues which could qualify.

And the decision was made that we would qualify only 12(g) securities under any circumstances, that is, a security filing regular reports with the SEC.

This necessitated a change in the schedule of the bylaws by the Board, and in connection with that change, the change was also made formally, stating that listed securities would be included.

And this was filed with the Commission and approved, and became our rules, so to speak.

This was the middle of 1970, approximately.

Senator WILLIAMS. Oh, I see. Then following that, there was a change—

Mr. DERRICKSON. There was another change, and that is the change, I think, which is the subject of your inquiry, as I take it. You are leading up to this change. This last change.

Senator WILLIAMS. Well, I knew it had been off again, on again, off again, on again, and I was just trying to trace it through.

Following your description of the bylaw that would include, on condition, there was a change of the bylaw that clearly stated no inclusion of listed securities; is that right?

Mr. DERRICKSON. That was in November.

Senator WILLIAMS. Of 1970?

Mr. DERRICKSON. 1970.

Senator WILLIAMS. And then a change came in 1971, when you went on the limited test?

Mr. DERRICKSON. That is right. March 1971 was a limited test of a list of 36 stocks selected from a list of all those that had been requested to be included by two marketmakers, which is a fundamental requirement for any issue—they were included in the system in March, and they were on a test basis until October, at which time it was opened for any security in which two dealers requested marketmaking status.

From that date on, there was a continuous inclusion of listed stocks.

Senator WILLIAMS. I see.

Mr. LOOMIS. Mr. Chairman, just to go back a little. At the time when they filed, sent the thing to the membership, and when they filed with the Commission, at the end of 1968, it was contemplated that they would start with the national list, as I have mentioned.

And that, of course, didn't include any New York Stock Exchange securities, although there was an indication that later on they would be considered.

Then in 1969, starting sometime during that year, maybe in the summer, they concluded that they would change the system and not limit it to the national list, but would include about double the number of securities that had previously been included.

Now this, of course, raised again the question of listed securities, and this was discussed, and there came a time in the end of 1969 and in the spring of 1970, when it was determined that upon this revised basis, listed securities would be included.

Senator WILLIAMS. When was there a suit filed?

Mr. DERRICKSON. December 1970. Immediately after the decision to defer the inclusion of listed stocks at startup. Their inclusion was never on any permanent basis.

In 1970—in December of 1970—the decision was to delay the inclusion at startup, pending study of problems—possible problems. The suit was filed shortly thereafter.

Senator WILLIAMS. What I would like to get a better understanding of is the decisionmaking process within the NASD on these questions, the changes of position, and the manner in which these conclusions were arrived at, which I don't have an appreciation of right now.

I will tell you, I have to go vote again. I wonder if there is any way to simplify our procedure here.

MR. MACKLIN. Can I give you a short answer?

Senator WILLIAMS. Yes; so we can have a summary statement. We know what our dilemmas are. Could you present this informally? We are not trying to hide anything from the public.

Excuse me.

(Recess.)

Senator WILLIAMS. We will reconvene.

Now, rather than going through minute question-by-minute question, can we synthesize now? Mr. Macklin?

MR. MACKLIN. I think it might be helpful, and I hope it is responsive to the direction of your inquiry, to trace the decisionmaking process of the NASD's 1970 decision, to exclude listed securities from the NASDAQ system at startup.

That was a change from a previous position, and started a chain of events that led to the study and to the final conclusion which was made this year.

So if that would be helpful to trace through that, we are working from memory and not from elaborate research, so trust me for being as accurate as I possibly can.

We had a NASDAQ committee meeting in August of 1970, and the NASDAQ committee was composed of some NASD Governors but also included some former Governors, and indeed, former Chairmen Gardner, Pearce, Freidrichs, and Eustis, and all of them had been familiar with the past discussions of this problem.

The background of that meeting was that we were coming down the homestretch, so to speak, as far as Bunker-Ramo having the system ready, and reaching some decisions on a number of policy questions.

I don't have the list of things they considered, but a good many of them were deferred pending further study or deferred pending startup of the system, because the emphasis at that time was on getting the system started.

The issue of listed securities on NASDAQ was brought up at that meeting, and discussed thoroughly, so much so that Chairman Gardner had each member of the committee express his personal opinion and what he thought should or should not be done.

And it was obvious from the simple poll of that, that the majority wanted to exclude listed securities from the system, at least at startup.

Not knowing what to do in light of the past events, Chairman Gardner was kind enough to turn to NASD's Chairman Teach and myself, and say, well now, you know the will of the committee, we will leave it in your hands to see what can be done.

I was relatively new on the job, as I mentioned, but did start at that time to review the events that led up to the previous decisions.

And like your remarks earlier, it left me, and even Chairman Teach, with a curiosity as to just what was the factual basis or the in-depth study that went into this decision, and we were curious as to just what was the Commission vote on this matter.

We had heard from past Governors, people that had been on the staff in the past, that it was done that way because that is the way the SEC wanted it done.

Now mind you, all the time we were trying to reconstruct the history of this, time was moving on. We were getting closer and closer to the time when Bunker-Ramo could start the system.

We had a number of projects moving forward, including the list of eligible securities which was to be distributed to each of the dealer-participants in the NASDAQ system before startup.

And at this particular point in time, our final list—this would be in late September or early October that we went over to see Chairman Budge, the particular day we went over to ask him some of the history of the Commission vote on this matter—why, our list of eligible securities was at that time at the printer.

So we either had to do something at that time, or forever hold our peace and distribute this list.

We visited with Chairman Budge, and left with the impression that the Commission had never taken a formal vote on this subject. We did tell him about the uneasiness of our NASDAQ committee and the past expressions of the Board, and asked if it would be appropriate that we write him a letter asking for permission to defer inclusion of NASDAQ's securities at startup.

He said he couldn't speak for the Commission, but obviously if we sent a letter, it would be considered.

We polled our executive committee by telephone, describing this set of circumstances, again not to be devious or sinister but just to live within the time frames that we were trying to adhere to to get the system started.

And at a vote from them to go forward, we sent a letter to the Commission asking for permission to defer this decision at startup. We sent the letter, and also polled our Board.

Well, we sent the letter to the Commission, and received a call from Chairman Budge that the Commission would be favorable to deferring inclusion of listed securities at startup, at which time we polled our Board by phone and by mail, sending them the letter to Chairman Budge.

We also had by that time some additional input. We had letters from the New York and American Exchanges, which we passed along to the Board just to give them a flavor of how the arguments were going.

So we had a vote of our Executive Committee, and a vote of our Board, to exclude the securities at startup, and a pending, or then a subsequent ratification by the SEC.

In our letter to the SEC, we asked, I believe, for a year to study this matter. And our thought about putting the year was to show our sincerity in studying the matter, rather than deferring indefinitely, and our letter back from the SEC didn't have anything about a time limit, which I think indicated that maybe they wouldn't, or they just didn't want, to take a position on whether a year was too much or too little.

We, of course, had a substantial amount of protest from some third market makers. And at our January Board meeting, why, we again considered this whole matter, including the proposition whether or not to have a test of essentially the securities that had been applied for inclusion in the NASDAQ system.

As I mentioned earlier, there were 36 securities out of about 2,300, so that it was a less than 2 percent of all the securities in the system.

The Board at that time felt they didn't have enough analysis of this to see whether to go forward with the test, and we called a special meeting for March in Washington, which at that time we reviewed the

matter in depth, and had the additional input of the SEC institutional study.

And the Board voted by a large majority to proceed with the test.

The test started on April 5, and the test results were monitored during the period and were reviewed at our Board meeting in September of 1971, at which time we noticed that we didn't have a lot of data on handling of blocks, and there were two or three other items where the Board would have liked to have more data.

We didn't want to cause a lot of economic hardship on third market makers, and we thought, with more stocks in the system, we might get a better supply of data.

So we broadened the test to include all securities that anyone wanted to put in, and extended the date to January 15, which was designed, among other things, to take it over the time of the SEC hearings on market structure. And as I said, they provided very valuable input.

Early in our plans, we had had substantial discussion about having hearings of our own. I am going to read excerpts from some answers we wrote to complaining third market dealers to show what our intent was at that time.

Here is one dated November 27, 1970, where we say—we sent him a copy of the Board's position. We say:

You will note that at this time securities have not been permanently barred, but only excluded from the system at start up, pending further studies of the many potential problems which inclusion in the system might present.

If you have additional thoughts that may help our study, we would be happy to hear from you.

We sent that to a number of people. We also—here is one: "You can be assured, in the course of the study all interested parties"—this is December—"all interested parties, including members of the investing public, will have an adequate opportunity to present their views." And so on and so forth. But that indicates——

Senator WILLIAMS. What was the procedure for the public to express their views?

Mr. MACKLIN. We hadn't organized our hearings yet, and as time went on, it became apparent that it would be better for us to participate in and monitor the SEC hearings, rather than hold hearings of our own.

This takes you up through our September Board meeting. In January, when our Board met again, the test was brought to a halt. And I am trying to think of the action at our January Board meeting, if any.

The NASDAQ securities that were in the system—the third market securities in the system, were, of course, left in the system. And then finally, the data from the test was gathered after the January completion and studied and voted on at the——

Mr. DERRICKSON. May 1972.

Mr. MACKLIN (continuing). May 1972 meeting. At which time, they were permanently included.

Mr. DERRICKSON. Could I add, please, that in November of 1970, the Board directed the staff of the NASD to send an explanation of what had happened which resulted in the change to exclude the listed securities at startup to all the membership and to the press.

So that it wasn't a question of not telling people what was going on. But it really was a question of trying to impart this information to the public, as well as to the membership.

And I think, as a result of that, we had no more than 15 to 20 letters in response. There seemed to be very little public interest, and limited dealer interest.

Senator WILLIAMS. On this question? On this question there was limited interest?

Mr. DERRICKSON. Yes.

Mr. MACKLIN. Based on the number of letters we received. I will say that the few dealers that were interested, were very interested.

Senator WILLIAMS. All right, now, to complete the picture, Mr. Loomis, could you review the Commission's information and attitude during the period we have been discussing, 1968 up until May of 1972?

Mr. LOOMIS. I will endeavor to do so. I may call on Mr. Pollack to fill in.

As I mentioned, at the end of 1968 the posture of the thing was that they were going to include, initially, securities on the national list. And they were going to consider expansion in the future.

And the Commission had accepted that general approach at that time.

By the fall of 1969, the NASD had reached the conclusion that they would have to expand the list of securities that would be initially available. It was our understanding, on the basis of conversations with people at the NASD, that a basic reason for this was that their membership wanted to have more securities in the system, and they felt this was needed in order to obtain a sufficient number of subscriptions and support from the membership so that this would work economically.

So they proposed, sometime after October 1969, to the Commission a revision to expand the list of securities. And there was a considerable amount of discussion with the staff of the Commission on that.

And the staff came back and reported to the Commission as to what those discussions had consisted of, and with drafts of possible amendments to the proposed rules.

And the conclusion came out—and Irv can perhaps tell the date—the NASD decided to do that, to expand the list.

Now, at that time, I wasn't on the Commission at that time, and so I can only attempt to reconstruct the Commission's reactions—it was a feeling that once you eliminated the national list as the criterion, and were going to admit other securities, the NASD would need to make a fairly strong showing if they wanted to exclude listed securities from that group.

I believe that this idea was communicated by the staff, or perhaps by the Commission—I wasn't at the Commission meetings at that period—to the NASD.

And in June of 1970, the NASD came in with a proposed amendment to its bylaws on the subject of NASDAQ, which would expand the group of securities and would, as I recall it, permit listed securities to be included.

And the staff recommended to the Commission that it not disapprove—which is the way the statute is worded—that proposal by the NASD, and the Commission did so.

Then in the fall of 1970, people commenced to express concern, some of which Mr. Macklin has outlined, concerning the inclusion of listed securities in the system. And as I recall, Mr. Haack and Mr. Saul wrote from the New York and American Stock Exchanges, to the Commission expressing certain reasons why they thought that listed securities should not be included.

Then in October of 1970, Mr. Macklin, as he pointed out, communicated with Chairman Budge and a letter came over from Mr. Macklin on behalf of the NASD, stating that they wished to modify their prior submissions to permit the exclusion of listed securities at startup.

And the Commission met and authorized the staff to convey to the NASD a general conclusion that the Commission would not object to that decision.

And then later, the Commission met again and approved a letter which Chairman Budge sent to the NASD, stating that the Commission would not object to the exclusion of listed securities at startup.

Mr. Macklin has mentioned the fact that there was a 1-year period suggested in his letter. The Commission felt that, as I understand it, it did not wish to underwrite that period. We—in fact, I think that many felt—again, I was not there—that it should be possible for the NASD to get into this question earlier than that, and we didn't want to write back and say you can take a year before you are visited.

So that went into effect, and in February of 1971, NASDAQ went into operation.

Now, as Mr. Macklin has told you, the NASD came to us thereafter and suggested that they wanted to make this test and they proposed an amendment to schedule D, the governing part of the structure that governs what securities are admitted, which would say that notwithstanding the prior criteria, the Board of Governors of the NASD could include any securities they wished for test purposes.

It was the feeling at the Commission that it was a good idea to have a test of the practical consequences of including listed securities, because we had been receiving representations from the exchanges that this would have very serious effects on them.

We weren't sure these effects would materialize. We had been receiving requests from at least one third market maker—I think only one, really made any vigorous statement of his position—that he thought that, as a matter of public policy and law, listed securities should be included.

Given these variety of views, the Commission concluded that it was a good idea to have a test made, and did not object to the amendment to allow the test to be made. The test, accordingly, was made.

I believe in September of 1971, the NASD gave us a report of the results of their test, as they saw it. And the Commission met and considered it.

I was on the Commission by that time, and we asked the staff for their analysis of the NASD study, and did it in the staff's view prove what it was supposed to prove.

And in October of 1971, we received from our staff a memorandum discussing the NASD study, and making various points, not all of which I now remember, but which in general indicated that they saw no particular reason to quarrel with the conclusions in that study, the 1971 study.

Then as Mr. Macklin has pointed out, in October, we went into our market structure hearings, and a considerable amount of testimony was taken. While those hearings were not directed to the question of whether listed securities should be included in NASDAQ, the issue was inevitably there, and we knew that because one of the major issues was how would the third market be fitted into a central market system, and what market information, quotations and so forth, should be provided, and in what way, and through what media.

The NASD, meanwhile, decided to expand its study. This did not require any formal filing with the Commission because the prior amendment to schedule D was broad enough to cover the expanded study.

So there were no formal filings made at that time, but the NASD informed our staff, and the staff informed the Commission. It is my recollection that the Commission met with representatives of the NASD.

In April of 1972, NASD completed their second or expanded study, and the results of that were thereafter transmitted to the Commission.

As a result of that study, the NASD proposed to in effect conclude in favor of the inclusion of all listed securities which met the standards that Mr. Macklin has outlined concerning the nature of the security and the number of market makers regularly making a market.

And their study tended to support that view. Again, we asked our staff for an analysis of that second study, which we have very recently received. And we have not, as I recall, as yet formally acted upon that second study because there was a feeling on the part of some of us that we should give this matter a little more thought, particularly in light of the fact that the whole context has changed since 1968 and 1969, and there is now the question of where this fits in, if it does, into the concept of a central market system. Does this point us down any road as to how this central market system should evolve, and if so, is that the road we want to be on?

And so that is about where it stands as far as the Commission is concerned now.

Senator WILLIAMS. While there might be some duplication in the record as we have made it this afternoon, at the conclusion of the case study, under the section "issues and questions" which you gentlemen have, there are some questions that have not been specifically raised, although they have been approached.

If there are additional comments you might wish to make concerning the questions we have not specifically covered, could you please submit them for our record.

Mr. LOOMIS. Well, I would certainly like to oblige. I just want a little more clarification, if I can get it; maybe I can get it from the staff, as to what questions they believe require further expansion and which have been discussed in some other way here.

We will certainly provide anything that they think they need to clearly complete the record.

Mr. MACKLIN. We certainly would. Would you like them in writing?

Senator WILLIAMS. Yes.

Mr. MACKLIN. We'd be happy to furnish anything else that you would like to have.

(The full statements of Mr. Loomis and Mr. Macklin follow. The answers to the questions may be found at p. 45.)

STATEMENT OF PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

SELF-REGULATION AND THE COMMISSION'S ROLE

As a part of your Committee's over-all examination of the securities markets and their evolution and regulation, you are interested, and properly so, in the decision-making processes used by the self-regulatory bodies and in the manner in which the Commission exercises supervision and oversight over these decisions. I understand that, as part of your review, you will consider at hearings today and tomorrow two examples of self-regulatory decision-making and Commission oversight, the decisions as to the inclusion of certain exchange listed securities in the NASDAQ electronic quotation system operated for the NASD and the adoption of rules by the New York Stock Exchange with respect to the sale of life insurance by its member firms. I further understand that in neither case do you propose to inquire into the merits of the decisions ultimately arrived at, but rather into the manner by which such decisions were made.

This use of case studies should produce a more concrete exposition of the decision-making process at work than would be likely to result from a general or theoretical discussion of that process, and I am very happy to have an opportunity to participate in what should be an illuminating analysis. At the same time, the examples you have chosen, while very interesting, are by no means typical of the type of decisions made by the self-regulatory bodies or by the Commission, primarily because they relate either to an activity by a self-regulatory body which has repercussions beyond the normal scope of its responsibilities or else relate to a matter which is, to a considerable degree, outside of the existing pattern of securities regulation.

At the outset, I would like to comment briefly on the decision-making processes, both of the self-regulatory bodies, and of the Commission in the exercise of oversight of their actions. The decision-making process in any organization is closely related to the structure of that organization, the distribution of authority both to initiate study and consideration of a question and to finally decide it for the organization, as well as the nature of any procedural requirements or formalities which may be proscribed, either by external authority or internally.

The Securities Exchange Act of 1934 says very little about the internal decision-making processes of the self-regulatory bodies, as distinct from the substantive standards to which their decisions must conform. That Act includes general principles such as "fair administration" and "fair representation," together with a fairly specific procedural outline for disciplinary decisions of the NASD found in Section 15A(b) (9) and (10). The general decision-making pattern for these bodies which appears to have been contemplated, and as it has evolved, seems to be modeled on that generally prevailing in the United States among private associations or corporations formed not to conduct business for a profit, but to provide services or other benefits to their members, or to the general public, or both. The pattern includes a governing board elected by the members, and a staff assigned to serve the board and carry out its decisions. The significance of the staff has been increased as the organizations have established the position of a full-time salaried chief executive officer. Structural or major decisions such as amendments to the constitution and by-laws and significant substantive rules require approval by vote of the membership.

These bodies do not act just like Government agencies, whose procedures and functions are derived from, and often proscribed by, statutes rather than from the decisions of those who choose to become members, and I think this distinction is essential to the concept of self-regulation. This does not mean that the decision-making processes of the self-regulatory bodies cannot be improved. There is an increasing awareness that their decisions affect persons other than their members, and that the voices of these other persons should be heard. This may well be true, incidentally, not only of the self-regulatory bodies in the securities industry, but also of other large and influential private associations. The self-regulatory bodies are moving in various ways to meet this need. The NASD is increasingly exposing proposed rules for public comment, a thing they never did a few years ago, and the major exchanges are significantly expanding public participation

in their governing boards. Further improvements will no doubt follow. I do not think, however, that the self-regulatory bodies should be saddled with the whole panoply of Government administrative procedure. I doubt if it would be suitable for a non-government organization, and I know, as a Government official for a good many years, and as a member of the Administrative Conference of the United States since 1968, that the field of Government administrative procedure is not without serious problems, including delay, cumbersome formalities, and unnecessary expense for all concerned.

Turning to Commission supervision or oversight, this can be exercised, as you know, in a variety of ways. In some instances, as for example in the case of floor trading and odd-lot trading, the Commission can simply write rules for the exchanges. In other years, particularly the definition of fraudulent or manipulative practices, the Commission can directly adopt rules which the self-regulatory bodies, together with the Commission are then obligated to enforce. Your concern, however, for purposes of the present case studies, is with Commission oversight or supervision of decisions made by the self-regulatory bodies, whether expressed in rules or otherwise. I just wanted to point out that this type of oversight, while significant, is by no means the only type which exists and is exercised.

With respect to the rules of the self-regulatory organizations, the Commission's authority under existing law is somewhat limited. The existing statutory pattern for oversight in this area has grown up piecemeal over the years since 1934 and contains quite a number of gaps and inconsistencies. In May of this year, we transmitted to the Congress draft legislation which we believe would not only provide a more consistent pattern, but, perhaps more importantly, would not only allow the Commission to exercise considerably more effective oversight and supervision with respect to rule-making by the self-regulatory bodies, but would avoid situations where the Commission simply cannot act at all where it probably should. One of your case studies may present that type of problem. The deficiencies in the statutory pattern for oversight have been discussed for many years. The Special Study of 1963 described them at length: they were given careful attention by the Supreme Court of the United States in the *Silver* case; and more recently, they were examined in the Commission's *Study of Unsafe and Unsound Practices of Broker-Dealers*, sent to the Congress in 1971. I will not attempt to go through this background except to refer, in the light of present concern about the adequacy of Commission oversight, to the fact that when, following the Special Study, the Commission adopted Rule 17a-8 requiring notice to the Commission of proposed exchange rule-making, a distinguished member of Congress who had responsibility for oversight of the Commission, suggested rather pointedly that, in his judgment, this rule was an undue and perhaps unlawful intrusion upon exchanges' rule-making processes.

We would urge that our proposed legislation, which has been introduced in the House of Representatives, be acted on promptly in order to further the continuing vigor and credibility of self-regulation by more adequate oversight.

Partly because of the lack of other procedures and partly for practical reasons, Commission oversight over the decision-making of the self-regulatory agencies has traditionally been carried on rather informally. This practice has been the subject of some criticism. The criticism may, in part, be justified, but, in large measure, it seems to be based on a misunderstanding of the nature and function of the whole process. Some observers view the relationship between the Commission, and, for example, the New York Stock Exchange as a self-regulatory body, as being essentially the same as the relationship between a regulatory agency and a regulated company, and they seem to suggest that the Commission should proceed in much the same way as, for example, the Interstate Commerce Commission proceeds when regulating the rates of a railroad company. This analogy is not apt.

The self-regulatory agencies, acting as such, are not simply regulated companies in a regulated industry; rather, pursuant to Congressional mandate, they share with the Commission the responsibility for regulating an industry—the securities business. Once this is appreciated, there is much to be said for the Commission's traditional informal approach, which is designed to help the self-regulatory bodies do their part of the job more effectively in the public interest, rather than confronting them as adversaries in an arena. When we discuss particular regulatory problems with a self-regulatory body, both we and they have an input of factual information and insight, and a result which reflects both their input and ours is not, as some have suggested, necessarily the product either of bargaining or of compromise.

This is not to say that there is no need for improvement in the processes of our oversight. In addition to the need in statutory changes which I have mentioned, there must be awareness of some of the unique characteristics and problems which self-regulation presents. A self-regulatory body draws its membership largely from members of the regulated industry. This is a source of strength insofar as they bring to the regulatory task practical business judgment and experience, which can hardly be duplicated in a Government agency, but it also creates problems insofar as self-regulatory decisions may be influenced by a desire to promote the economic interests of members or of a particular group of members, or by a wish to preserve or obtain a competitive advantage. It is not true, however, that a regulatory decision which has an impact on the relative competitive position of various segments of the industry is, for that reason, necessarily wrong or even corrupt. Regulatory considerations, such as the protection of unsophisticated investors or the maintenance of orderly markets, may require limitations upon the unfettered pursuit of competitive aims, but I believe that, to the extent compatible with the public interest, competition rather than regulation should be relied upon and encouraged. Oversight should not only insure, but also appear to insure, that regulatory decisions are not made for other than regulatory purposes.

Procedures for Commission oversight of self-regulatory action require a balancing between the opportunity for frank and uninhibited discussion of policy issues and the need to give all persons, whether members or not, who may be affected by the action a chance to make their views known. In response to this, the Commission has increasingly in recent years developed procedures for public participation in this process. We have held extensive public hearings on such significant questions as exchange commission rates, institutional membership and the future structure of the securities markets. Following the latest set of hearings, the Commission issued its Statement on the Future Structure of the Securities Markets in which it articulated its general conclusions and approach, based upon the record thus made, to a number of major questions and also pointed out directions in which it believed the securities industry must move. This policy statement has been followed with various steps towards its implementation.

Procedures must be accommodated to their purposes. Thus, we believe that where the self-regulatory bodies or the Commission, or both, are engaged in formulating policy or establishing rules or standards for future conduct, the function, and therefore the appropriate procedure, is of a quasi-legislative nature and should resemble the fact finding and the deliberative practice of a legislative body, rather than the trial of a lawsuit. Last week, we issued a notice of proposed rule-making with respect to Membership on Registered Securities Exchanges, for other than Public Purposes, (Exchange Act Release No. 9716, August 3, 1972) in which we outlined the procedures to be followed in that proceeding and the reasons for their selection. These procedures are basically quasi-legislative.

This is a period of rapid change in the securities markets in which difficult policy decisions have to be made. Procedures for decision-making must also change, but I do not think they should be confined within rigid molds. There is still a need for experimentation to find the procedures best suited to the tasks and decisions before us.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF
SECURITIES DEALERS, INC.

We welcome this opportunity to appear today to discuss the inclusion of listed stocks in the NASDAQ System. Congratulations are in order for the comprehensive factual statement prepared by your staff.

It is obvious that neither the NASD nor the Commission was in possession of facts upon which to make a considered judgment as to the impact of including listed stocks in the NASDAQ System in late 1970. It was well known that "Third Market" trading had existed for many years and such trading has been expanding. Currently, the Third Market share volume in NYSE-listed issues represents trading is less than 4%. With the exception of the New York Stock Exchange and, as a percentage of total NASDAQ share volume, Third Market NASDAQ trading is less than 4%. With the exceptions of the New York Stock Exchange volume, total NASDAQ volume is more than that of all other exchanges combined.

It appears to us, based on recent figures, that approximately 75 firms will

make over-the-counter markets in about 900 stocks listed on all exchanges. There are now 91 exchange-listed issues included in the NASDAQ system, traded by about 50 market makers.¹ Currently, there are about 3,400 securities listed in NASDAQ traded by 625 market makers. Thus, even though the NASDAQ system has been available for virtually all exchange-listed securities since October, 1971 these issues represent only 2.7% of all the issues in the system. Third Market makers are only 8% of total market makers and those exchange-listed issues trade in NASDAQ still represent a relatively small percentage of all exchange-listed issues traded over-the-counter.

During the past six months the Securities and Exchange Commission has been encouraging the development of a central market system for all trading in listed securities including that of Third Market Makers. Among its primary aims are requirements relating to disclosure of last sale and quotation information and a set of rules for participating market makers which would develop a base for uniform regulation among various markets. It is also studying problems associated with a composite tape and transacting reporting. In view of these developments the Board of Governors has appointed a Committee on Third Market and Disclosure which is now addressing and reviewing regulatory problems in this area.

The original decision to exclude listed stocks from NASDAQ can probably be said to be based on the economics of the system and lack of in-depth knowledge of Third Market activities. In the middle 1960's the need for a nationwide system for the instantaneous distribution of OTC quotations became clearly apparent to all in the industry. Technological progress had advanced to the point where it was feasible to consider implementing a "NASDAQ" type concept at about the same time that the obtaining of quotations via telephone became so hectic as to be almost overwhelming. The demand for a system was urgent but success in establishing one was difficult to predict. The fact that NASDAQ did work so well is a considerable tribute to Bunker Ramo Corporation and to those members of the Automation Committee of the NASD and its Board who participated in its planning and implementation.

Immediately prior to start-up on February 8, 1971, it was not known whether the system would function or would function as planned. Indeed, situations arose where dealers in large areas of the country could not update their quotations because regional "concentrators" did not function. The system operators, at our insistence, subsequently installed back-up equipment in each region. More than 20 million dollars had been expended by Bunker Ramo in design and installation. It was imperative for the industry that the system go on line at the earliest possible moment and staffs of Bunker Ramo and the NASD worked continuously toward early implementation.

The question of inclusion of listed stocks was of secondary importance to start-up of the system. The needs of the over-the-counter market dictated that there be no delay since, for the first time, nationwide instantaneous disclosure of all quotations in the system, approximately 2,300 could be obtained if the System worked. The decision to delay inclusion of listed stocks at start-up, pending study of possible problems, and the gathering of information and data upon which to make a final determination as to these problems appeared reasonable and desirable. Needless to say, we believe that the procedures by which this was accomplished and the ultimate decision reached were fair and reasonable. While it is true that a few have argued that conflicting economic interests of some members played an unfair part in the decision making process, we do not believe that to be the case. Progress is usually accompanied by adjustment and change brings certain dislocations, but this is not to say that unfair or shortsighted decisions always result when those having conflicting interests are the decision makers. In addition, it should be pointed out if any unfairness or arbitrary or capricious action were taken by our Board it is always subject to SEC oversight and court review. We believe that these safeguards have been and will be sufficient deterrents to prevent undue influence or the taking of unfair advantage for economic reasons.

Prior to start-up, the Board decided that it would be desirable to undertake a program to educate and inform the industry and the public as to the NASDAQ potential. Basically, we think the NASD should, in the public interest, undertake to publicize and disseminate information relating to new and significant matters. We attempted to do this in connection with NASDAQ in order to gain

¹ According to a recent survey 5 market makers handle about 77% of all Third Market share volume.

acceptance of and support for the System and also because of the forthcoming change in patterns of trading over-the-counter securities. NASDAQ is evolutionary, many changes have taken place since start-up, both technically and regulatory, and continuing change can be expected. Quotations must be firm for a normal unit of trading, and volume must be reported or disciplinary action may be instituted. Future enhancements will deal with transaction reporting, automatic telephone connection to the dealer making the best market, and clearance and settlement through inter-face with the National Clearing Corporation. It is the function of regulators, self or governmental, to guide and regulate these processes as directed by the Congress.

Other ramifications of NASDAQ are and will be worthy of industry and public attention. For example, the decision as to whether a company should list on an exchange or continue to be traded in NASDAQ. Because of NASDAQ the difficulties in making this decision have been considerably broadened. Depending upon the issue involved and its particular circumstances, there is a question as to whether it is to the advantage of the issuer to remain in NASDAQ, with an average of approximately 6.6 market makers, in various cities, or is it preferable to become listed with trading concentrated in only one specialist on an exchange floor? Before NASDAQ, when volume of trading was not available in over-the-counter securities, and when instantaneous quotations were not available at the touch of a finger, a decision might have been made more easily to list on an exchange.

As newspaper coverage of NASDAQ trading expands, including publication of last sale information, the listing decision will become even more difficult, and as additional information as to NASDAQ securities is disseminated, old discriminations, such as state registration requirements which exempt exchange stocks from full filing requirements but require such for NASDAQ stocks, should be eliminated. Also to be considered is the impact of NASDAQ on marginability of non-listed securities.

Our efforts to distribute information, which may easily be identified as competitive with other markets, indicates quite clearly that it does not matter that economic conflicts are present in the Association's governing board. The 1934 Act and NASD rules require that the Board be fairly and equitably representative of its membership. Currently, there are 4,300 NASD members and of these 1,100 are members of exchanges. About 544 are members of the New York Stock Exchange. These first participate widely in the over-the-counter industry and it is an important part of their overall business mix. Information available from annual financial reports filed by members indicate that for the year 1970 gross securities income for NASD members was nearly \$5 billion. Of this amount \$2 billion was from exchange trading, and \$1.4 from over-the-counter commissions and principal business. The remaining \$1.6 billion was derived from other securities activity such as general underwriting and mutual fund sales. While no two firms are the same, the fact that the firm may participate broadly in exchange as well as over-the-counter markets should not disqualify one of its representatives from making fair and honest decisions as an Association Board member, rather it should be encouraged. Our experience clearly shows that a man's first allegiance is not a stock exchange simply because his firm happens to be a member.

The procedures followed in reaching the ultimate decision as to listing stocks in NASDAQ we consider to have been reasonable and proper.

Obviously, it would have been desirable to have information available both statistically as well as comment from the industry, public and government, so that an informed decision could have been made prior to start-up. Unfortunately, this was not possible. The overwhelming priority at the time was implementation of the System so that the ultimate beneficiaries, the public, would have available rapid and accurate quotations.

The decision to delay inclusion did not interfere with Third Market trading. It did provide an opportunity, in view of the problems raised, to evaluate and test and to reach an informed judgment on this question. The procedures were sanctioned by the SEC, and shortly after the decision to delay was reached in November, 1970, a special report to members and the press was distributed so they would be aware of the controversy. We received critical responses from approximately 15 to 20 members, to whom we replied that full consideration would be given to their views. Under the circumstances then prevailing, solicitation of the membership and request for public comment would almost surely have resulted in lengthy delay in start-up of the System. This would have been very difficult to justify because of the need for the System by the industry and

also because it was important that revenues commence in view of the considerable investment by the System Operator, and because of the large degree of risk involved both in technical performance as well as in acceptance and usage by industry members.

The NASD desired comment from all sources in respect to important regulatory matters, and it is our policy to obtain such comments prior to adoption of new by-laws and rules. While the report to members cannot be said to satisfy solicitation for comment, we believe this approach was a reasonable first step and sound in view of the limited time available before the System could commence operations.

It appears to us that the SEC properly fulfilled its role in this matter. It would have been premature for the SEC to conduct a formal proceeding in 1968. Negotiations were underway with Bunker Ramo; however, a contract had not been signed and it was not known whether the risk would be undertaken by them. Further, substantially less facts and data were then available upon which to base a decision than were available in early 1972 after our test and the comprehensive SEC hearings.

Prior to and throughout the 1970-71 period there was little known about trading activity or patterns of institutions, and since most Third Market trading is with institutions (in excess of 79% as reported in our study), it was important to consider the possible results of the Institutional Study which was in process by the SEC. In late 1970 it was thought that this document might provide assistance in making a permanent decision. In addition, it should be remembered that the period 1968 through 1970 was one which had never before beset the industry and resulted in catastrophic losses and a recommendation for restructuring if the industry which is not yet completed. In 1969 hearings were conducted on the operational and financial condition of the industry and there emerged the absolute need for a nationwide uniform system for clearing and settling over-the-counter securities, its transactions. These matters were of paramount concern to the industry, its regulators, and the Congress as is well documented by establishment of Securities Investors Protection Corporation in December 1970. The Martin Report, dealing with the restructuring of the New York Stock Exchange, was in preparation in mid-1971 and in October 1971 the SEC conducted hearings on the future structure of the industry, including the role of the Third Market. The Martin Report issued in August 1971 could be read to recommend the elimination of the Third Market. Numerous witnesses testified at the Commission hearings in respect to the Third Market, including the NASD. In our statement on November 11, 1971, we said: "NASDAQ, a national communication system which is adapted to use by all securities exchanges already exists. Fuller use of these facilities for reporting of the quotations and transactions of the various markets will stimulate compensation which is in the public interest. We believe it desirable to fully explore and implement the potential of the NASDAQ System including expansion of its quotations capacity and potential for trade reporting."

Thus, during the test period, hearings were held and all parties interested had adequate opportunity to express their views to the governmental agencies concerned with the regulation of the nation's securities markets. The solutions are simple, and intricate, complex, and long-range problems are involved, many of which will not be resolved in short order. In sum, we believe it is difficult to say that any informed solution was possible within the very short time frame presented immediately prior to the NASDAQ start-up.

We were aided in our thinking and deliberations concerning a test of listed securities in NASDAQ through conferences with representatives of Weeden & Co. in late 1970. This organization was then responsible for about 50% of Third Market trading. In such discussions we made it clear that we would act promptly in presenting this possibility to the Board. It must be remembered that at that time there existed a possibility of an appeal to the courts of the SEC's approval of the NASD delay at start-up, and there also existed the possibility of direct approach to the courts for an injunction staying the implementation of the system without listed stocks. The filing of the private litigation was an added factor for consideration. The unusual and unique complex circumstances surrounding NASDAQ implementation are not likely to be again presented. The testimony at the SEC's market structure hearing, the information contained in the Institutional Study, and the test results themselves, in retrospect, clearly indicate the differences of views and the complexity of the problems, some of

which (including disclosure requirements for trading in listed securities) are still being studied by SEC and Congress.

As you are aware, the NASD has operated since its by-laws and rules were originally approved by the SEC in 1939 with full Commission oversight of its actions. It has been our view that because of the extensive governmental oversight and because of the provisions of Section 15A(n) of the 1934 Act to the effect that the Maloney Act should prevail if in conflict with any other provision of law, that any necessary anti-competitive aspects of NASD regulation is protected against antitrust attack. Because of a similar need in 1970, in enacting the Investment Company Act Amendments, Congress repeated the protective provisions of Section 15A(n) in the 1940 Act, in order to protect the Association from attack in respect to responsibilities delegated to it in regulating mutual fund sales charges.

Recent court decisions have indicated the need for Congressional review of these statutes so as to immunize the NASD from antitrust attack as to actions taken in good faith in accordance with its by-laws and rules and with the approval of the SEC. It seems to us that the strictures of the Sherman and Clayton Acts should not apply to the government approved acts of a quasi-governmental, non-profit, self-regulatory organization in the same manner they apply to normal competitive profit making enterprises. Treble damages and the recovery of attorneys' fees make sense as a matter of public policy to aid in the enforcement of the antitrust laws. It is not clear that this same public policy should prevail where bona fide attempts have been made with governmental oversight in the public interest in response to Congressional authority.

We are appreciative of this opportunity to present this statement as well as of the great efforts of this Subcommittee throughout the past year in investigating industry problems. We stand ready at all times to assist it.

Senator WILLIAMS. Very good. You have been most cooperative.

This basic study and this hearing will be a leavening of the whole process in the changing world. Thank you very much.

(Whereupon, at 4:35 p.m., the hearing was recessed, to be resumed the following day, Wednesday, August 9, at 2:00 p.m.)

APPENDIX TO PROCEEDINGS CONDUCTED ON

AUGUST 8

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., October 27, 1972.

HON. HARRISON A. WILLIAMS, Jr.,
*Chairman, Subcommittee on Securities, Committee on Banking, Housing and
Urban Affairs, United States Senate, Washington, D.C.*

DEAR SENATOR WILLIAMS: In connection with your Subcommittee's study of the self-regulatory process, you have posed certain questions concerning the decisions involved in the inclusion of listed securities in NASDAQ, the nationwide computer-based information system of the National Association of Securities Dealers, Inc.

Pursuant to your request, I have annexed my responses to these questions. Although some of the questions posed appear to be directed specifically to the NASD, I have set forth some general comments with respect to these questions as well. As you are aware, some of the matters raised in the questions you posed were discussed during my testimony before your Subcommittee on August 8 of this year and in my general statement on self-regulation which I represented earlier this month. In order not to inconvenience the Subcommittee, I have indicated those portions of the response to your questions which I have previously discussed.

I trust that the attached responses will be helpful to you in your difficult tasks. If I can be of further assistance to the Subcommittee or its staff, please do not hesitate to advise me.

Sincerely,

PHILIP A. LOOMIS, Jr.,
Commissioner.

Response of Securities and Exchange Commission to Questions Concerning the Inclusion of Listed Securities in NASDAQ

INTRODUCTION

Your Subcommittee already has graciously accorded me an opportunity to express some of my views on self-regulation generally¹ and on these studies in particular.² I believe, however, that a general word about this case study of NASDAQ is in order before I proceed to respond to the specific questions you have raised.

As I noted in my prior appearances before you,³ this study is somewhat atypical; it seeks to inquire as to a decision making process that commenced in 1964 and did not come to fruition until early 1971, and it involves a rather unique occurrence—the development of a complex computerized quotations system. This development should be viewed in context. The NASD has been concerned with quotations almost from its inception. It became fairly early the principal source of quotations for over-the-counter securities which appeared in newspapers. These quotations were collected and disseminated to the press by, or under the auspices of, NASD committees. Generally speaking, quotations were

¹ See Remarks of Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, "The Structural Operation of the Regulatory System in the Securities Industry" (Oct. 5, 1972) (hereafter, "Remarks").

² Testimony of Philip A. Loomis, Jr. Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs (Aug. 8 and 9, 1972) (hereafter, "Testimony").

³ Remarks, *supra* n. 1, at p. 1; Testimony, (Aug. 8), *supra* n. 2, at pp. 11-12.

collected the day before they appeared in the press, and therefore, did not necessarily reflect the current market. In addition, for most of the period prior to 1964, the inter-dealer quotations were arbitrarily adjusted to provide a spread to accommodate retail selling. The evolution of the NASD quotations system and the problems which it presented were extensively discussed in the Report of the Special Study.⁴ This retail quotations system, although it involved a substantial investment of time and effort by the NASD, was not operated pursuant to any express statutory mandate, and the NASD, at times, took the position that it could abandon the effort if it should choose to do so.⁵ The *Special Study* recommended that the NASD quotations system should be revised and reformed and that it should be conducted under an express statutory mandate. In response to this recommendation, Congress enacted Section 15A(b)(12) of the Securities Exchange Act,⁶ as added in 1964, and the NASD, commencing in 1964, set about developing an automated quotations system, utilizing electronic data processing and modern communications technology. This was a major undertaking involving commitments in the millions of dollars and presenting a host of technological, economic and regulatory questions. A totally new and vastly improved quotations system for over-the-counter securities has resulted.

The question of the inclusion of listed securities in NASDAQ should be considered against this background. While this, like other questions involved in the system, presented a knotty problem, it was by no means the only one; in fact, because this was such a major and complex undertaking, it must have appeared distinctly secondary, if not peripheral to many who were involved.

In the development of NASDAQ, the Commission and its staff, as evidenced by the documents which underlie your study, were in close and constant contact with responsible officials of the NASD. Various ideas and concepts were discussed freely and, as far as practicable, fully, during the six years that it took to make NASDAQ a reality; and, I might add, no one purported to reach any definitive conclusions about the appropriate form NASDAQ *ultimately* should take. Accordingly, I believe that there may be some confusion generated by the references contained in the Subcommittee's questions to "decisions" rendered in the early formulation of the system that ultimately became NASDAQ or "reversals" of these early "decisions."⁷ While changes in the NASD's By-Laws were, on several occasions, submitted to the Commission and subsequently adopted by the NASD, I believe it was understood that a system as novel and unique as NASDAQ could evolve only after careful evaluation, not only of theory and legal concepts, but of the logistical and other pragmatic considerations inherent in an undertaking of this kind.

Indeed, even at this time, there are issues and problems still to be resolved—but they can and will be resolved only after empirical experience is available upon which to predicate any judgments that are made. In a situation such as this, the flexible, informal process of discussion and negotiation which marks the administrative process proves most valuable.

1. *Are self-regulatory organizations in a position to reach fair and constructive decisions on questions which involve largely economic issues between different classes of members, or between members and nonmembers?*

In answering this question in the context of your Subcommittee's NASDAQ study, I think it is appropriate to note that the Congress which adopted the Maloney Act amendments to the Securities Exchange Act of 1934,⁸ did intend national securities associations to make initial decisions involving, among other things, economic issues.⁹ Thus, the House Committee, in its report on the Maloney

⁴ *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2 at pp. 630-645, 665-670, 674-678 (1963) (hereafter, "*Special Study*").

⁵ *Special Study*, *supra* pt. 2, p. 639.

⁶ 15 U.S.C. 78o-3(b)(12).

⁷ See Questions 4, 5, 6, 7, 8 and 15 *infra*, pp. 12, 21 and 33.

⁸ See S. 3255, 75th Cong., 3d Sess. (1938).

⁹ The House Committee, considering the Maloney Act amendments, also noted two additional regulatory areas to which that bill was intended to be responsive:

"First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry; second, to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market. . . ."

H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4 (1938); *accord*, S. Rep. No. 1455, 75th Cong., 3d Sess. 3 (1938).

Act amendments, gave emphasis to the economic, as well as disciplinary, aspects of over-the-counter regulation, stating that these amendments were intended, among other things,

"to afford to the investor an economic service the efficiency of which will be commensurate with its economic importance, so that the machinery of the Nation's markets will operate to avoid the misdirection of the Nation's savings, which contributes powerfully toward economic depressions and breeds distrust of our financial processes (emphasis supplied)¹⁰

Similarly, it was understood by Congress in the adoption of the Maloney Act amendments, and subsequently by the Commission in its implementation of the directives of those amendments, that the creation of national securities associations envisioned by the Maloney Act—equipped with initial regulatory authority over their members—would entail decision making and other activities by the associations that would have a direct and substantial economic impact, not only on members of the associations, but on nonmembers as well, including economic impacts with decided anti-competitive overtones.¹¹

This very subject of quotations has involved the NASD in economic issues and decisions. Perhaps the most significant was the decision, made in response to a *Special Study* recommendation, that the quotations appearing in the newspapers and later on NASDAQ should reflect the wholesale or inter-dealer market rather than be adjusted to reflect a so-called "retail" market, making allowance for a retail commission or markup. Many in the NASD felt that to publish wholesale prices would cripple their selling efforts. Others believed, as did the *Special Study*, that investors would understand the situation and that the public interest required published quotations reflecting the actual bid and asked prices of market makers.¹² The NASD adopted the latter alternative,¹³ notwithstanding economic pressure from its retail members.

2. Should the NASD "promote" the interests of the over-the-counter market in competition with exchange markets, in the same manner as the exchanges "promote" the interests of their markets?

3. If so, to what extent should firms whose principal economic attachment is to the exchange markets be permitted to participate in decisions involving inter-market competition?

Promotion of the over-the-counter markets, in the broadest sense—that is, inspiring and increasing public confidence in and utilization of the over-the-counter market—is not only expected of the NASD, it is, in large measure, the reason for the adoption of the Maloney Act amendments, pursuant to which the NASD was formed.

The legislative history of the Maloney Act amendments evidences serious Congressional concern with the importance and impact of trading in the over-the-

¹⁰ H.R. Rep. No. 2307, *supra* n. 9, at p. 4; *accord* S. Rep. No. 1455, *supra* n. 9, at p. 3. See also, Section 15A(b)(8) of the Securities Exchange Act, 15 U.S.C. 78o-3(b)(8), which provides that the rules of all registered securities associations must be designed, *inter alio*, "to promote just and equitable principles of trade. . . , 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. . . ."

¹¹ Strictly speaking, membership in the NASD—the only national securities association to register with the Commission pursuant to the Maloney Act amendments to the Securities Exchange Act—is voluntary. As a practical matter, however, a broker or dealer in securities who is not a member of the NASD is excluded from a sizable segment of the securities business, since under the Maloney Act the NASD is given the power to adopt rules which would prohibit members from dealing with nonmembers except on the same terms and conditions as the member affords the general public. See Section 15A(i)(1) of the Securities Exchange Act, 15 U.S.C. 78o-3(i)(1). See also, *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 441 (1945): *Special Study*, *supra* n. 4, pt. 4, at p. 605. This accords with the legislative purpose. The House Committee on Interstate and Foreign Commerce stated, at the time it reported on the Maloney Act bill, that ". . . it is contemplated that exclusion from membership in a registered securities association will be attended and implemented by economic sanctions."

H.R. Rep. No. 2307, *supra* n. 9, at p. 9; *accord*, S. Rep. No. 1455, *supra* n. 9, at p. 8. cf. *Silver v. New York Stock Exchange*, 373 U.S. 341, 349 (1963).

¹² *Special Study*, *supra* n. 4, pt. 2, at pp. 666-668, 677-678.

¹³ See *Block & Co. v. National Association of Securities Dealers, Inc.*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶91,489 (D.D.C. 1965), *stay denied*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶91,490 (C.A.D.C. 1965, where a group of members unsuccessfully sought to enjoin the NASD from carrying out this decision.

counter market¹⁴ and a fear that the failure to provide firm regulation of practices and trading in the over-the-counter market would cause trading on regulated exchange markets to transfer to an essentially unregulated over-the-counter market.¹⁵ In adopting the Maloney Act amendments, Congress intended to foster competition between the exchange markets and over-the-counter market, but not competition founded upon the absence of meaningful regulation of the latter market. Thus, Section 15A(b)(8) explicitly requires that national securities association rules be designed, in part (emphasis supplied),

"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. . . ."¹⁶

It is my view that when the NASD embarks upon a program such as the NASDAQ System—a program calculated to improve the operations or standards of its members, to upgrade the kind of services its members furnish to the investing public, and otherwise to implement the broad legislative goals Congress envisioned as the touchstone of self-regulation of the over-the-counter market—the NASD is, in fact, "promoting" the interests of the over-the-counter market in competition with exchange markets.

The Maloney Act amendments contemplated that members of a national securities association with conflicting interests would be represented in the government of the association,¹⁷ and that the association itself would adhere to the standard of the public interest, not the economic interest of some or necessarily even a majority of its members.¹⁸ The fact that some NASD members also are exchange members is, if anything, further reason for permitting their views to be represented and considered in the final decision making processes of the NASD. The decisions made will involve these members most directly, and their knowledge of exchange practices may prove useful in considering alternative courses of conduct. Unless it were to be concluded that exchange members could have no voice in the government of the NASD—a conclusion that I believe would be inimical to the basic concept of self-regulation—I see no reason to deny these members an effective, as opposed to a dominating, part in the affairs of the NASD. It should be noted of course, that the possibility that a conflict of interest might generate an unfortunate rule change or proposal is vitiated materially by the fact that the Commission maintains its statutorily-mandated oversight of NASD activities.¹⁹

Similarly, where NASD actions have a significant public impact—that is, an impact which extends beyond the confines of the NASD's membership, I believe interested members of the public also should be given an opportunity to express their views.²⁰ At the present, the NASD is taking several steps to implement

¹⁴ See, e.g., S. Rep. No. 1455 *supra*, n. 9, at p. 2, where it was noted that: "the over-the-counter markets . . . are immense, the activities embraced therein are varied, and they are of the utmost importance to the national economy. . . ."

"[T]he over-the counter markets not only provide the medium for an immense volume of trading in a great variety of securities, but they also provide the principal channel by which the savings of the nation flow into new financing. . . ."

"[T]he over-the-counter markets are national in a dual sense: First, because of their immense importance to the national economy; second, because the actual operations of these markets are interconnected on a national scale."

Accord, H.R. Rep. No. 2307 *supra*, n. 9, at pp. 2-3.

¹⁵ See S. Rep. No. 1455, *supra* n. 9, at p. 3; H.R. Rep. No. 2307 *supra* n. 9, at p. 3; S. Rep. No. 792, 73d Cong., 2d Sess. (1934), at p. 6; H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), at p. 15-16.

¹⁶ 15 U.S.C. 78o-3(b)(8). See also, S. Rep. No. 1455, *supra* n. 9 at p. 3 and H.R. Rep. 2307, *supra* n. 9, at p. 4, quoted *supra* p. 5.

¹⁷ See *Special Study*, *supra* n. 4, pt. 4, at p. 608; *Hearings on S. 3255 Before the Senate Comm. on Banking and Currency*, 75th Cong., 3d Sess. (1938), at p. 22 (statement of Commissioner Mathews); see also, *Hearings on S. 3255 and H.R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. (1938) at p. 15 (statement of Commissioner Mathews). See also *Remarks*, *supra* n. 1, at pp. 13-17.

¹⁸ See Securities Exchange Act Sections 15A(b)(6) and 15A(b)(8), 15 U.S.C. 78o-3(b)(8).

¹⁹ See Securities Exchange Act Sections 15A(j) and 15A(k), 15 U.S.C. 78o-3(j) and 78o-3(k); *Hagen Investments Inc., v. Securities and Exchange Commission*, 460 F. 2d 1034, 1038 (C.A. 10, 1972).

²⁰ See *Remarks*, *supra* n. 1, at p. 20.

these objectives through the use of "public" governors²¹ and the publication of significant rule proposals for public comment.²²

4. *Should the decision on inclusion of listed securities have been submitted to the full NASD membership or decided by the Board of Governors?*

5. *Did the membership vote on the by-law changes, in light of the language in the attached memorandum [submitted to NASD members in November 1968 to solicit their approval of the NASDAQ System], constitute a membership decision in favor of inclusion?*

6. *Should the decision have been subject to reversal by the Board of Governors of the NASD without a resolicitation of the membership and an opportunity for public comment?*

Questions 4, 5 and 6 posed by the Subcommittee may suggest a possible misconception of the procedures which led to the implementation of NASDAQ.

In November, 1968—more than two years before the NASDAQ System commenced operations—the Board of Governors of the NASD submitted to the NASD membership proposed amendments and additions to the By-Laws of the Association. As the memorandum accompanying these proposals made clear to the membership, the purpose of these By-Law changes was to authorize the NASD's Board of Governors "to organize and operate an automated quotations system for the over-the-counter market, and to adopt rules under which the System will operate, including rules in areas such as qualifications of registered market makers, standards for authorized securities, charges to be collected by the operator of the System, and procedures for persons who may believe they are aggrieved by action taken by the Board of Governors in respect to operation of the System."²³

Proposed Article XVI of the By-Laws also authorized the Board to "incorporate such rules, charges, qualifications, standards and procedures into a new Schedule 'D,' " which Schedule, when adopted by the Board, would become part of the By-Laws; and would contain the "actual procedures" essential to the functioning of the NASDAQ System.²⁴

The membership was advised that, because of the designation of formal procedures for review of any discretionary action taken by the Board of Governors, and because of the newness and still unresolved questions concerning the definitive format of the NASDAQ undertaking, broad discretion would be left with the Board of Governors with respect to modifying or adding to the new System's rules, charges, qualifications, standards and procedures, set forth in Schedule "D". In asking the membership to delegate this broad authority to it, the Board of Governors stated:

"The approach of having the fundamental operating procedures in a Schedule [subject to change by the Board of Governors without membership vote] rather than in the Article [of the By-Laws] itself is believed to be the most practicable for the successful administration of the NASDAQ System. Otherwise, each change, *such as a revision in the requirements for authorized securities for the purpose of increasing the number of issues included in the System*, would have to be subjected to the time-consuming procedure of a membership ballot."²⁵

The NASD membership specifically was advised that approval of the suggested procedures contained in the By-Law amendment proposal could result in changes in the operating format, within the broad discretion granted the Board of Governors, prior to start-up of NASDAQ and that such changes were likely to be made.²⁶

²¹ See Article IV, Sec. 3, of the By-Laws of the NASD, CCH *NASD Manual* ¶1403, at 1103. Two "public" members of the Governing Board of the NASD already have been selected by the other Governors of the NASD.

²² See *Remarks*, *supra* n. 1, at pp. 20-21.

²³ See Memorandum, dated Nov. 11, 1968, from NASD Board of Governors to NASD membership, re: "Mail Vote Concerning Amendments and Additions to the By-Laws of the Association Dealing with the Establishment of an Automated Quotations System," at pp. 1-2 (hereafter, "November 1968 memorandum").

²⁴ *Id.* at p. 2. A copy of Schedule "D", which the Board of Governors expected to, and did, adopt after receiving membership approval of the By-Law amendment proposal, was attached to the November 1968 memorandum "so that members may review the contemplated operating procedures and contemplated charges for service insofar as they have been developed to date." *Ibid.*

²⁵ *Ibid.*

²⁶ See *id.* at p. 2 (emphasis supplied):

"Work is still underway in the development of charges for teletypewriter terminal service and for optional devices designed to facilitate the entering of volume data and quotations into the NASDAQ System. As a result, it is anticipated that proposed Schedule "D" will, from time to time, be amended by the Board of Governors to reflect such charges. Changes or additions in other areas could also become necessary or desirable between now [November 11, 1968] and start-up time."

On the basis of the foregoing, I believe that the membership of the NASD was fully apprised of the fact that they were being asked to approve, in principle, the broad structure of an automated quotations system and were being asked to leave the details of the actual operation of the System to the judgment and discretion of the Board of Governors of the NASD, subject, of course, to clearly defined procedures to challenge any action authorized by the NASD Board of Governors and to Commission oversight.²⁷ While the NASD's membership could have rejected this type of approach and required the Board of Governors to submit each proposal for amending the Association's rules governing the operation of the NASDAQ System to the membership for approval, I believe the approach actually taken to have been essentially well-founded.²⁸ At the time these By-Law changes were submitted to the NASD membership, the NASDAQ System was still in the developmental stages. Under these circumstances, I believe that it was appropriate and expedient for the NASD membership to grant its Board of Governors discretionary power to amend Schedule "D" to the By-Laws, as necessary to resolve promptly questions concerning the operational and other details of the NASDAQ System as it evolved into final form.

While the November, 1968 memorandum and the attached proposed Schedule "D" indicated that exchange-listed securities could be considered for inclusion in NASDAQ after "start-up,"²⁹ I believe that the NASD membership was fully advised that this contemplated provision with respect to listed securities, as well as any other provision then in Schedule "D", was subject to change in the discretion of the Board of Governors as NASDAQ developed further, and was *not* a final decision.³⁰

In fact, during the period between November, 1968 and the commencement of NASDAQ in February, 1971, the NASD Board of Governors did adopt several amendments to Schedule "D" to the By-Laws as the need for changes in the developing system became apparent. One such amendment to Schedule "D", filed with the Commission on June 5, 1970, for "non-disapproval" pursuant to Section 15A(j) of the Securities Exchange Act, provided, among other things, that exchange-listed securities which otherwise met the qualifications of authorized securities, would be included in the NASDAQ System from "start-up."³¹ At the time of this amendment, as I recall, the NASD Board of Governors had tentatively concluded that it was necessary, prior to commencement of the NASDAQ System, to expand the system to include more securities than then appeared on the NASD's National List, in order to promote subscriptions by members to the NASDAQ System, and also tentatively concluded that exchange-listed securities should be eligible for inclusion in the System at "start-up." Subsequently, as this Subcommittee is aware, the NASD Board of Governors received comments from the New York and American stock exchanges, and others, which pointed out possible problems which might result if exchange-listed securities were included in

²⁷ Article XVI, Section 3 of the NASD By-Laws, CCH, *NASD Manual* ¶ 1653, at 1133-1134.

²⁸ Compare the emergency powers delegated to the Board of Governors by Article VII, Section 1 of the NASD By-Laws, CCH, *NASD Manual* ¶ 1501, that were approved by the Commission and affirmed by one federal court in *Hagen Investments, Inc. v. Securities and Exchange Commission*, 460 F. 2d 1034 (C.A. 10, 1972) with Article XVI, Section 3 of the NASD By-Laws, *supra* n. 27.

²⁹ The NASD's memorandum stated (emphasis supplied):

"The NASDAQ System has been developed to provide an automated quotations system for securities traded over-the-counter. *If an application were received* on a security which is also listed on a stock exchange and there were an active, over-the-counter market for the security, it would be necessary to consider whether under the circumstances the security meets established standards for inclusion in the System."

November 1968 memorandum, *supra* n. 23, at p. 3.

The memorandum and the attached draft Schedule "D" to the By-Laws made clear that, at the commencement of NASDAQ, *only* securities on the NASD's National List were to be included in the NASDAQ System and that, after "start-up", the NASD Board "[i]n its sole discretion" could determine whether to authorize any other securities—including those listed on registered national securities exchanges—for inclusion in the NASDAQ System. *Id.* at p. 3; *Schedule "D" to the Proposed Amendments to the By-Laws of the National Association of Securities Dealers, Inc.*, dated Nov. 11, 1968, at p. 10.

³⁰ November 1968 memorandum, *supra* n. 23, at p. 2.

³¹ See Letter, dated June 5, 1970, to Ernest L. Dessecker, Securities and Exchange Commission, from John J. McCarthy, Jr. Office of the General Counsel, National Association of Securities Dealers, Inc., filing amendments to Schedule "D" of the NASD By-Laws, pursuant to Section 15A(j) of the Securities Exchange Act.

NASDAQ at "start-up,"³² and finally concluded, in light of the fact that the problems raised were not so speculative as to be beyond the realm of possibility, that it would be best to exclude listed securities at the commencement of NASDAQ "so that potential problem areas could be studied while the system was operating."³³ The Board so advised the NASD membership and the Commission.³⁴

Accordingly, I do not believe that the membership vote on the By-Law changes reasonably can be construed as a membership decision in favor of including exchange-listed securities in NASDAQ. Nor do I believe that the membership of the NASD properly could or should have concluded, as suggested by the Subcommittee's questions, that securities listed on national securities exchanges would be included in NASDAQ after the system had become operative and final procedures had been established. In the implementation of any new system such as NASDAQ, a period of experimentation is necessary and the NASD's Board of Governors merely proposed that it be given, and the NASD membership authorized the Board to exercise, sufficient latitude to commence the System with a broad range of non-exchange-listed securities and the authority to test and phase-in other securities as experience with the new System was gained.³⁵

Since the November, 1968 memorandum did not state that securities listed on national securities exchanges, that also were traded in the over-the-counter market, definitely would be included in the NASDAQ System after its start-up, but, instead, left that question open and subject to the continuing consideration of the NASD's Board of Governors,³⁶ I am unable to concur in the implication of the Subcommittee's Question 6 to the effect that the eventual decision of the NASD's Board of Governors, in October and November 1970, to commence NASDAQ without the inclusion of quotations for securities also listed on national securities exchanges, constituted a "reversal" of the decision that previously had been made by the NASD's general membership in approving the By-Law changes discussed above.³⁷

In a similar vein, I do not believe that "an opportunity for public comment," to which the Subcommittee refers in Question 6, predicated as it is upon what I believe to be the assumption of a "reversal" by the NASD Board of Governors of a decision to include exchange-listed stocks in NASDAQ, would have assisted in a meaningful analysis of the self-regulatory decision making process which led to NASDAQ. The ultimate determination reached by the NASD's Board of Governors was simply to test the effect of the inclusion of exchange-listed securities in NASDAQ. While I have, of course, referred the Subcommittee on prior occasions to my belief that significant policy determinations by the self-regulatory agencies should have the benefit of the public's views,³⁸ I see no reason to believe that public comments, which could have been based only on speculation and generalized opinion prior to the start-up of the NASDAQ System, would have been significant.

³² See, e.g., Letter, dated Oct. 22, 1970, from Gordon S. Macklin, President, National Association of Securities Dealers, Inc., to Hamer H. Budge, Chairman of the Securities and Exchange Commission; Letter, dated Oct. 9, 1970, from Ralph S. Saul, President, American Stock Exchange to the Securities and Exchange Commission; Letter dated Oct. 13, 1970, from Robert W. Haack, President, New York Stock Exchange, to Hamer H. Budge, Chairman of the Securities and Exchange Commission; National Association of Securities Dealers, Inc., *Special Report to NASD Members*, SR3 (November 1970).

³³ See National Association of Securities Dealers, Inc., *Special Report to NASD Members*, SR3 (November 1970), at p. 1.

³⁴ *Ibid.*, See also, Letter, dated Oct. 22, 1970, from Gordon S. Macklin, President, National Association of Securities Dealers, Inc., to Hamer H. Budge, Chairman of the Securities and Exchange Commission.

³⁵ Cf. *Hugen Investments, Inc. v. Securities and Exchange Commission*, *supra*, n. 28, 460 F. 2d 1034; *Delta Air Lines Inc. v. Civil Aeronautics Board*, 455 F. 2d 1340 (C.A.D.C., 1971).

³⁶ See discussion *supra*, pp. 15-16 and n. 29.

³⁷ In connection with this reading of the November 1968 memorandum submitted by the NASD's Board of Governors to the Association's general membership on the background of NASDAQ, it is pertinent to point out that, within one month of the commencement of NASDAQ, the NASD Board of Governors in fact voted to include a test group of 36 exchange-listed securities in the NASDAQ System for a specific period of time, and, since that time, the NASD Board of Governors has voted to include exchange-listed securities in NASDAQ on a regular basis. See National Association of Securities Dealers, Inc., Press Release No. NSD 2371, March 15, 1971, at p. 1; Letter, dated July 7, 1972, from Gordon S. Macklin, President, National Association of Securities Dealers, Inc., to Ernest L. Dessecker, Records and Services Officer, Securities and Exchange Commission.

³⁸ See, e.g., *Remarks*, *supra* n. 1 at p. 20; *Testimony* (August 8), *supra* n. 2, at p. 13; and my response to this Subcommittee's questions with respect to the self-regulatory determinations concerning the sale of life insurance by member firms of certain registered national securities exchanges, at pp. 12-13.

7. In view of the controversy over the subject, should the SEC have conducted a formal proceeding before reaching a decision in 1968?

8. Whether the 1968 position was in fact only a staff position, or reflected a Commission decision, should the SEC have conducted a formal proceeding before reversing that position in 1970?

9. Does the confusion over what the SEC had or had not done indicate the need for more "formal" procedures in passing on questions of this nature?

As I have indicated in my opening comments in response to the Subcommittee's questions regarding the decision making process which led to the implementation of NASDAQ,³⁹ the Commission did not reach "a decision" in 1968, as suggested by Question 7, with respect to the ultimate propriety or necessity of including exchange-listed securities in NASDAQ. In 1968, the NASD was advised by the Commission's staff that restrictions against the inclusion of exchange-listed securities in NASDAQ should be predicated clearly upon policies contemplated by the Securities Exchange Act,⁴⁰ and that has been the Commission's consistent position throughout this matter. The NASD's Board of Governors, of course, ultimately did decide not to include listed securities in the NASDAQ System at the start-up of that System, predicated upon possible technical, operational and regulatory problems that, on their face, were not so speculative as to be beyond the realm of possibility.⁴¹ Accordingly, when the NASD later requested permission to commence NASDAQ without the inclusion of exchange-listed securities,⁴² the Commission did not decide that the exclusion of listed securities on a *permanent* basis was appropriate. Indeed, this question never was presented to nor decided by the Commission. The NASD's precise request was to be given sufficient time to test the effect of including exchange-listed securities in the NASDAQ System and to weigh the results implicit in such a move, in light of all of the regulatory objectives embodied in the Securities Exchange Act.

When viewed in this appropriate context, I do not perceive any basis for suggesting that a "formal" proceeding should have been held on this matter, or that the informal procedures employed were inappropriate.⁴³ I do believe, of course,

³⁹ See pp. 2-3, *supra*.

⁴⁰ See Letter, dated Apr. 10, 1968, from Irving M. Pollack, Director of the Commission's then Division of Trading and Markets, to Richard B. Walbert, President, National Association of Securities Dealers, Inc.:

"The Commission is of the view that, under these provisions [of the Securities Exchange Act—namely, Sections 15A(b)(8) and 15A(b)(12)] and in the light of national policies expressed in other federal statutes designed to promote free competition, any restrictions [on the inclusion of exchange-listed securities] of the kind noted above should be based on some clearly defined and overriding policy contemplated by other provisions of the [Securities Exchange] Act.

"The Commission therefore suggests that you discuss these questions further with the Division [of Trading and Markets] in the near future with a view to your preparing a full written presentation exploring these questions and making appropriate recommendations for consideration by the Commission."

⁴¹ Among other reasons, the NASD suggested the following bases for its conclusion not to include exchange-listed securities in NASDAQ at the start-up of the System:

"1. Possible technical difficulties that may arise as a result of the sheer size and complexity of the system.

"2. The possible effect on exchange markets.

"3. The possible creation of investor confusion as a result of different prices and volume on the same security.

"4. The possible diversion from our original purpose to focus investor attention on over-the-counter companies, which prior to NASDAQ did not benefit from the availability of current quotations and accurate volume and statistical data.

"5. The possible confusion and added cost to the industry of the dual surveillance, volume reporting, issuer disclosure requirements and related detection techniques necessary to supervise the total activity in securities markets."

National Association of Securities Dealers, Inc., *Special Report to NASD Members*, SR3 (November 1970), at p. 1. See also letter, dated Oct. 22, 1970, from Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc., to Hamer H. Budge, then Chairman of the Securities and Exchange Commission. In addition, the NASD advised the Commission that it "received requests from only five potential market makers in respect to approximately 34 listed issues. In no instance did more than one market maker express an intention to make a market in the same security. Thus, to date no listed security would qualify for authorization in the [NASDAQ] System." *Id.* at p. 2.

⁴² Letter, dated Nov. 5, 1970, from Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc., to Mr. Ernest L. Dessecker, Securities and Exchange Commission, enclosing copies of amendments to Schedule "D" of the NASD's By-Laws for filing pursuant to Section 15A(j) of the Securities Exchange Act.

⁴³ The reference contained in the Subcommittee's introduction to these questions to the "informal bargaining process" carried on between the Commission and the NASD presumably relates to what the Subcommittee terms the NASD's "prefiling" of draft rules with the Commission's staff. See Securities Industry Study of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, *Examination of the Decisions Involved in the Inclusion of Listed Securities in NASDAQ* (Aug. 8, 1972),

as I have stated in my prior appearances before this Subcommittee,⁴⁴ that the receipt of public comments is an appropriate method of ensuring effective decision making by the self-regulatory agencies, as well as the Commission, but this procedure, I believe, should be utilized in the context of definitive, as opposed to interim or short-term and experimental, decisions or policy changes.

10. *Would a full public hearing likely have produced a prompter and more orderly decision in favor of the test by which the questions were ultimately answered? Might it have produced a decision against the conduct of such a test?*

11. *Which side should have had the "burden of proof" in any public proceeding on this question? Should the proponents of inclusion of listed securities have been required to provide affirmative justification for their position to overcome concern about adverse changes that might result? Could they do so? Or should the opponents have been required to present evidence of specific dangers to overcome the concern about the anti-competitive impact of their position? Could they do so?*

I do not believe that a "full public hearing" would have hastened any decisions in favor of the test by which the question whether to include exchange-listed stocks in NASDAQ ultimately was answered. The implication conveyed by the term "full public hearing" is one of a procedure in which the comments and views of the public formally are solicited and all interested persons are afforded an opportunity to make their views known—either orally or in writing. Since the essential decision here was simply to determine whether and how to make a determination to include exchange-listed securities in NASDAQ—a decision that was made as expeditiously as possible—in light of all the circumstances I cannot conclude that any benefit would have resulted from the utilization of the more cumbersome procedures suggested by the Subcommittee's question. Since most persons concerned were agreed that a decision concerning the inclusion in NASDAQ of exchange-listed securities could not be made without the benefit of empirical data,⁴⁵ which in turn could only result from actual experience with the System, it is doubtful whether a full public hearing would have produced a decision not to conduct such a test.

Question 11 posed by the Subcommittee seems to embrace the concept that policy decisions of this nature are adjudicative in nature. I cannot concur. The decision making process involved here seems strictly one of a legislative, rather than an adjudicative, nature and, accordingly, I do not believe it is useful to analyze the decisions by which the NASDAQ System evolved in adjudicative terms such as "burden of proof" or "burden of persuasion." The task of the NASD and the Commission in the context of the NASDAQ System was a legislative task—namely to isolate and resolve the legal and policy issues arising by virtue of the NASD's proposal. The Commission's position consistently has been that, on questions of access to a significant market facility such as NASDAQ, rules which appear to deny access should be justified on the basis of regulatory objectives encompassed by the Securities Exchange Act.⁴⁶ In such a context, there are no correct, incorrect or definitive answers. A question of policy is always a question of judgment in light of broad principles; adjudicatory questions generally are those involving the application of existing legal standards to definitive conclusions of fact.⁴⁷ For this reason, the Commission did not seek then nor would I recommend now that a "burden of proof" be placed on pro-

at p. 8. I believe that informal consultations of this nature serve a very valuable service, a conclusion generally conducted in by the Commission's 1963 study of the securities markets. See *Special Study*, *supra* n. 4, pt. 4, at pp. 717-718. That study found these informal practices to be a major factor in achieving greater responsiveness on the part of the NASD to the needs and interests of the public. *Id.* And, because these informal procedures largely were an outgrowth of the requirements for advance filing by the NASD of proposed rule changes contained in Section 15A(j) of the Securities Exchange Act, 15 U.S.C. 78o-3(j), they led directly to a recommendation by the *Special Study* for the adoption of formal advance filing requirements by the nation's securities exchanges that later were incorporated in Securities Exchange Act Rule 17a-8, 17 CFR 240.17a-8. See *Special Study*, pt. 4, at p. 727.

⁴⁴ See *Remarks*, *supra* n. 1, at p. 20; *Testimony*, *supra*, n. 2, at p. 13.

⁴⁵ See, e.g., Letter, dated Oct. 22, 1970, from Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc., to Hamer H. Budge, Chairman, Securities and Exchange Commission; Letter, dated Nov. 19, 1970, from Irving M. Pollack, Director of the Commission's then Division of Trading and Markets, to Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc.; National Association of Securities Dealers, Inc., *Special Report to NASD Members*, SR3 (November 1970).

⁴⁶ See p. 21-22 and n. 40, *supra*.

⁴⁷ See Attorney General, *Manual on the Administrative Procedure Act* (1947), at pp. 14-15; *American Airlines Inc. v. Civil Aeronautics Board*, 359 F. 2d 624, 629-630 (C.A.D.C.) (en banc), *certiorari denied*, 385 U.S. 843 (1966).

ponents of any given matter raising policy questions. In the Commission's consideration of NASDAQ, we merely sought to have the NASD explore the issues raised in order to ascertain whether there were, under the circumstances, satisfactory policy reasons which would warrant the exclusion of exchange-listed securities from NASDAQ. The initiative for resolving these questions, I believe, rested in the first instance with the NASD, pursuant to the scheme of "cooperative regulation" embodied by the Maloney Act amendments to the Securities Exchange Act.⁴⁵

12. *To what extent did the emphasis on negative aspects of the inclusion of listed securities result from the absence of public input on the merits of the issue, or the influence of groups opposed to such inclusion? (In other words, would the decision likely have been different if there had been a full public hearing on the subject?)*

Although the NASD necessarily based its decision to experiment before reaching a definitive conclusion on the question of including exchange-listed securities in NASDAQ on the existence of possible adverse effects of such inclusion, I do not believe this decision would have differed if there had been a full public hearing on the matter. I believe that the Subcommittee's question presumes that the NASD did not receive conflicting viewpoints with respect to the question of whether listed securities should be included in the NASDAQ System. This, of course, was not the case—during its consideration of this matter the NASD was addressed by the proponents and opponents of the inclusion of exchange-listed securities in NASDAQ and considered various points of view before decision upon the test approach that led to ultimate resolution of the issue.⁴⁶

I do not believe that there is any basis for the implicit assumption in the Subcommittee's question that the NASD's decision was based on the influence of any particular group or point of view, and it is clear to me that the regulatory questions expressed concerning the inclusion in NASDAQ of exchange-listed securities were not unreasonable.⁴⁷ Some, for example the question of short sales in the third market, had never been studied fully, and certain of the other questions, particularly those related to the basic structure of our securities markets already were the subjects of Commission concern,⁴⁸ or were soon to form the basis of extensive studies on market structure.⁴⁹

13. *What were the principal factors that led the NASD Board to change its position in early 1971 to favor the prompt test of listed securities?*

I am not aware that the NASD changed its position with respect to its decision to conduct, as promptly as practicable, a test of the effects of including exchange-listed securities in NASDAQ. Even prior to the implementation of NASDAQ, the NASD Board, on January 19, 1971, voted to have its automation committee study the various problems of including exchange-listed stocks in the System and asked that committee to formulate a plan for a test.

14. *Is there any rational procedure by which speculative regulatory problems can be weighed against speculative consequences of restraint on competition? Should there be a general presumption for, or against, competition in the decision making process of the SEC and the self-regulatory organizations?*

In my opinion, the most effective and rational procedure by which speculative regulatory problems can be weighed against speculative consequences of restraints on competition is the course of action adopted by the NASD in connection with its determination of the effect of the inclusion of exchange-listed securities in NASDAQ. By a carefully controlled program of testing, it became possible to reach a more informed judgment as to whether the possible regulatory problems were speculative or real and, conversely, whether a decision, either way in the particular case, would involve any significant restraints on competition. This

⁴⁵ See S. Rep. No. 1455, *supra* n. 9, at p. 4. H.R. Rep. No. 2307, *supra* n. 9, at pp. 4-5.

⁴⁶ See, e.g., Letter, dated Oct. 9, 1970, from Ralph S. Saul, *supra* n. 32; Letter, dated Oct. 13, 1970, from Robert W. Haack, *supra*, n. 32; Letter, dated Oct. 30, 1970, from Donald E. Weeden, Chairman of the Board, Weeden & Co., to the Board of Governors, National Association of Securities Dealers, Inc.; Letter, dated Nov. 6, 1970, from Harry V. Keefe, Jr., President, Keefe, Bruyette & Woods, Inc., to Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc.; Letter, dated Nov. 6, 1970, from Aaron Netburn, Senior Vice President, New York Hanseatic Corporation, to Gordon S. Macklin, President, National Association of Securities Dealers.

⁴⁷ See p. 22 and n. 41, *supra*.

⁴⁸ See, e.g., Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971).

⁴⁹ See Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* (Feb. 2, 1972).

approach to possible but speculative consequences, where practicable, as here, appears rational. Where testing is not practicable, the weighing of speculative consequences is necessarily a matter of judgment to be based on all available information. Testing the consequences, by a phased-in and flexible process, where this can be done, as it often can, seems more likely, however, to produce realistic answers.

Competitive aspects of regulatory action are certainly matters to be considered by the Commission and the self-regulatory organizations in their decision making, but since all regulatory action taken by these bodies must conform to those standards set forth in the Securities Exchange Act—standards which are not necessarily inconsistent with anti-competitive impacts—I do not believe that it is appropriate to indulge in presumptions in determining the impact of a regulatory course of conduct.

15. Is it likely that the NASD Board would have reached its earlier position on the exclusion of listed securities if it had been required to state publicly the reasons for its decision and the regulatory needs which justified the competitive restraint?

The Subcommittee's question again assumes that the NASD Board of Governors reached a final decision to exclude exchange-listed securities from the NASDAQ System, when, in fact, as I already have noted,⁶³ this was not the case. The only final conclusion reached by the NASD prior to the commencement of the NASDAQ System was to conduct appropriate tests to determine the proper resolution of the question whether exchange-listed securities should be included in the System. In any event, when the NASD presented its concerns over the inclusion of exchange-listed securities to the Commission, the Commission communicated its belief that such a decision would have to be premised upon an appropriately detailed consideration of each of the ramifications of such a course of action.⁶⁴ When the NASD did decide temporarily to exclude exchange-listed securities from the NASDAQ System, a public announcement of this determination was made, as the documents underlying the Subcommittee's study indicate.⁶⁵ Accordingly, I see no basis to conclude that the determinations reached would have been substantially altered had the NASD been "required" to state publicly the reasons for its decision.

16. Should more formalized procedures be developed for considering the anti-trust questions involved in a decision of this type? Who should participate in those procedures, and on what basis?

As the documents underlying the Subcommittee's study make clear,⁶⁶ anti-competitive questions were considered both by the Commission and the NASD throughout the decision making process that ultimately led to the exclusion of exchange-listed securities at the commencement of the NASDAQ System. While, as I have indicated above,⁶⁷ the Congress that enacted the Maloney Act amendments recognized the necessity of certain anti-competitive elements inherent in the creation of the national securities associations envisioned by that Act, I believe it was expected that both the securities associations formed and the Commission would give appropriate consideration to the anti-competitive impacts of their regulatory action. I do not believe, however, that procedures can be formalized so that in every instance of regulatory action the same factors—anti-competitive and otherwise—should be considered or should be considered to the same extent.⁶⁸ Similarly, I do not believe that in every instance the same persons or agencies should participate in considering these anti-competitive matters. The Commission, I believe, should be able to weigh anti-competitive or other considerations in passing upon the activities of the NASD in a manner and to the extent consistent with the aims of the Securities Exchange Act and the nature of the

⁶³ See pp. 12–20, *supra*.

⁶⁴ See pp. 21–22, *supra*, and see pp. 10–11, and n. 19, *supra*, for a discussion of the impact of the existence of Commission oversight in such a context.

⁶⁵ See, e.g., Letter, dated Nov. 6, 1970, from Harry V. Keefe, Jr., President, Keefe, Bruyette & Woods, to Gordon S. Macklin, Jr., President, National Association of Securities Dealers, Inc.; National Association of Securities Dealers, Inc., *Special Report to NASD Members*, SR3 (Nov. 1970); *Wall Street Journal*, (Oct. 29, 1970), at p. 17.

⁶⁶ See, e.g., Letter, dated April 10, 1968, to Richard B. Walbert, President, National Association of Securities Dealers, Inc., from Irving M. Pollack, Director of the Commission's then Division of Trading and Markets; Memorandum on Access to the NASDAQ System prepared for the NASD, August 26, 1968, at pp. 21–23.

⁶⁷ See p. 6, *supra*.

⁶⁸ Compare, in an analogous context, *Municipal Electric Association of Mass. v. Securities and Exchange Commission*, 413 F. 2d 1052 (C.A.D.C. 1969) with *City of Lafayette v. Securities and Exchange Commission*, 454 F. 2d 941 (C.A.D.C., 1971).

proposed action. To the extent that the nature of the question under consideration permits and warrants, interested persons should be accorded an opportunity to provide the decision making body the benefit of their views and expertise.

17. *Did the availability of private relief under the antitrust laws have a significant effect on the final resolution? Was it a constructive effect?*

The Subcommittee's final question seems to assume that private relief against the NASD was available under the antitrust laws based on the NASD's action temporarily excluding exchange-listed securities from NASDAQ. This question I believe, at the very least, remains open.⁶⁹

Whether the *possibility* that private antitrust relief might be available had any impact on the NASD's decision to conduct a test of the effect of including exchange-listed securities in NASDAQ, is a question that I believe is more appropriate for the NASD to answer. The Commission, of course, was concerned with the propriety of the NASD's proposals and the justifications therefor.

SECURITIES AND EXCHANGE COMMISSION,
OFFICE OF THE COMMISSIONER,
Washington, D.C., October 30, 1972.

Mr. H. HOLTON WOOD, Jr.,
Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs,
New Senate Office Building, Washington, D.C.

DEAR MR. WOOD: Pursuant to your request, I am enclosing a copy of the memorandum filed by the Commission as *amicus curiae* on December 16, 1971, in *Shumate & Co., Inc., v. National Association of Securities Dealers* (N.D. Tex., CA-3-4361-C) and *Shumate & Co., Inc., v. American Stock Exchange* (N.D. Tex., CA-3-4708-D).

Sincerely,

KATHRYN B. MCGRATH,
Legal Assistant to Commissioner Loomis.

⁶⁹ See *Shumate & Co., Inc. v. National Association of Securities Dealers, Inc.*, Civ. No. CA-3-4361-C (N.D. Tex., filed Dec. 14, 1970) and *Shumate & Co., Inc. v. American Stock Exchange*, Civ. No. CA-3-4708-D (N.D. Tex., filed June 15, 1971).

In *Silver v. New York Stock Exchange*, 373 U.S. 341, 358 n. 12 (1963), the Supreme Court made clear that where the Commission possesses jurisdiction to consider self-regulatory conduct, the holding of the court—that the antitrust courts had jurisdiction to consider the anti-competitive implications of exchange disciplinary proceedings—might not be applicable. The court stated:

"Were there Commission jurisdiction and ensuing judicial review for scrutiny of a particular exchange ruling as there is under the 1938 Maloney Act amendments to the Exchange Act . . . a different case would arise concerning exemption from the operation of laws designed to prevent anti-competitive activity, an issue we do not decide today."

The *Shumate* litigation is still pending and the Commission has submitted a memorandum to the court in the proceedings as *amicus curiae*, urging that the delicately balanced regulatory scheme embodied in the Maloney Act amendments would be seriously undermined if the forum of an antitrust court, applying primarily antitrust standards and sanctions, were available to review a decision making action of the NASD subject to the oversight of the Commission.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS

SHUMATE & CO., INC.,

Plaintiff,

v.

NATIONAL ASSOCIATION OF SECURITIES
DEALERS, et al.,

Defendants.

CA-3-4361-C

SHUMATE & CO., INC.,

Plaintiff,

v.

AMERICAN STOCK EXCHANGE, et al.,

Defendants.

CA-3-4708-D

MEMORANDUM OF THE SECURITIES AND
EXCHANGE COMMISSION, AMICUS CURIAE

G. BRADFORD COOK
General Counsel

DAVID FERBER
Solicitor

RICHARD E. NATHAN
Assistant General Counsel

Securities and Exchange
Commission
Washington, D.C. 20549

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS

SHUMATE & CO., INC.,	:	
	:	
Plaintiff,	:	
	:	
v.	:	CA-3-4361-C
	:	
NATIONAL ASSOCIATION OF SECURITIES	:	
DEALERS, et al.,	:	
	:	
Defendants.	:	

SHUMATE & CO., INC.,	:	
	:	
Plaintiff,	:	
	:	
v.	:	CA-3-4708-D
	:	
AMERICAN STOCK EXCHANGE, et al.,	:	
	:	
Defendants.	:	

MEMORANDUM OF THE SECURITIES AND
EXCHANGE COMMISSION, AMICUS CURIAE

In these actions Shumate & Company, Inc., a securities broker and dealer, alleges that the National Association of Securities Dealers ("NASD") ^{1/}

^{1/} The NASD is an "association of brokers and dealers" registered with the Commission as a "national securities association" pursuant to Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3.

and others ^{2/} have violated and are violating the antitrust laws, 15 U.S.C. 1, et seq., in connection with the operation of an automated system for the dissemination of price quotations for securities traded over-the-counter, called NASDAQ. ^{3/} Shumate alleges generally that in the interests of the New York Stock Exchange ("NYSE") and the American Stock Exchange ("AMEX"), the defendants have conspired to prevent dissemination through NASDAQ of price information with respect to securities listed and traded on the exchanges, although listed securities are often traded over-the-counter in what is known as the "third market." Both complaints ask treble damages on behalf of the class of broker-dealers who are not members of those

2/ In addition to the NASD, Shearson, Hammill & Co., Inc., a member firm of the New York Stock Exchange, is a party defendant in No. CA-3-4361-C (the NASD action). The American Stock Exchange and its then president Ralph S. Saul; the New York Stock Exchange and its president Robert W. Haack; Gordon S. Macklin, president of the NASD; Gordon L. Teach, Chairman of the NASD's board of governors and vice president of Shearson, Hammill; and Jonathan C. Calvert, a member of the NASD's board of governors, are defendants in No. CA-3-4708-D (the AMEX action).

In a third antitrust action Shumate challenges Rule 394 of the New York Stock Exchange, Shumate & Co., Inc. v. New York Stock Exchange, No. CA-3-4663-D. While considerations of the same type as are discussed herein appear relevant to that action, we take no position as to the pending motion for dismissal in that case.

3/ NASDAQ refers to NASD Automated Quotation system.

exchanges. 4/ In the NASD action, plaintiff also asks that the Court effect a "change in the By-Laws of Defendant N.A.S.D. as to the composition of its Board of Governors," apparently to prevent alleged undue influence by exchange members in the decisions of the NASD. 5/ In the AMEX action, in addition to damages, an injunction is sought to prevent "discriminat[ion] against listed securities in the make up of securities to be included in the NASDAQ System merely because such securities are listed on National Exchanges." 6/

The defendants have moved to stay these actions pending resolution of important questions of regulatory policy by the NASD and the Securities and Exchange Commission. The Commission submits this memorandum to apprise the court of its views concerning certain issues raised by the defendants' motions.

4/ Complaints in No. CA-3-4708-D at pp. 15-16; in No. CA-3-4361-C at p. 13.

5/ Complaint in No. CA-3-4361-C at p. 13.

6/ Complaint in No. CA-3-4708-D at p. 16.

THE CHARACTER OF THE REGULATORY SCHEME OF THE SECURITIES EXCHANGE ACT MAKES IT INAPPROPRIATE FOR THE COURT TO GRANT RELIEF THAT WOULD, IN EFFECT, REQUIRE THIS COURT TO SUBSTITUTE ITS JUDGMENT FOR THAT OF THE COMMISSION ON MATTERS OF REGULATORY POLICY.

The antitrust allegations of the complaints require an examination of the regulatory scheme of the Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq., both as it relates to the NASD generally and as it relates to the NASD's activities in connection with the NASDAQ system. When a complaint seeks a form of relief under the antitrust laws that is wholly inimical to a statutory regulatory scheme, the Supreme Court has invariably found that the district court would be without jurisdiction to grant such relief. See, Far East Conference v. United States, 342 U.S. 570 (1952); Georgia v. Pennsylvania R.R., 324 U.S. 439, 453-455 (1945); United States Navigation Co. v. Cunard Steamship Co., 284 U.S. 474, 485 (1932). Cf. Carnation Co. v. Pacific Westboard Conference, 383 U.S. 213, 221 (1966) (dictum). The Supreme Court has upheld direct application of the antitrust laws to regulated entities only where this will not disrupt a statutory regulatory scheme. See United States v. Philadelphia National Bank, 374 U.S. 321 (1963); United States v. Radio Corporation of America, 358 U.S. 334 (1959). But even in such circumstances, as the Supreme Court noted in Philadelphia National Bank, 374 U.S. at 353, "judicial abstention" is required "in cases where protection of the integrity of a regulatory scheme dictates preliminary resort to the agency which administers the scheme." Under this doctrine district court action will often be postponed while the agency's views are obtained.

Registration with the Commission under Section 15A of the Securities Exchange Act provides the NASD with the benefits and responsibilities of a statutory scheme providing for

"cooperative regulation, in which the task [of regulation of the over-the-counter market in securities] will be largely performed by representative organizations of investment bankers, dealers and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation."

S. Rep. No. 1455, 75th Cong., 2d Sess., p. 4 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess., p. 5 (1938). Subsection (n) of Section 15A, 15 U.S.C. 78o-3(n), provides:

"If any provision of this section is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provision of this section shall prevail."

It seems generally to be assumed that in some cases this provision will prevent application of the antitrust laws to the NASD. See United States v. Socony-Vacuum Oil Co., Inc., 310 U.S. 150, 227 n. 60 (1940); International Ass'n. of Machinists v. Street, 367 U.S. 740, 810 n. 16 (1961) (Frankfurter, J., dissenting); II Loss, Securities Regulation 1370 (2d Ed. 1961) and V Loss, Securities Regulation 3469-3470 (Supp. to 2d Ed. 1969); cf. Silver v. New York Stock Exchange, 373 U.S. 341, 358 n. 12 (1963). The scope of this antitrust exemption has not been extensively explored in any judicial proceeding. The Court of Appeals for this circuit has, however, stated in Harwell v. Growth Programs, Inc., C.A. 5, No. 30501, October 15, 1970, Slip Op. p. 12 (emphasis added):

"This section, by its terms, grants no specific antitrust immunity. However, it seems that if conduct is permitted,

authorized or required by this Act, Congress intended that such action would not be prohibited by any law in force on June 25, 1938, including the anti-trust law." 7/

While the Supreme Court has not passed upon the meaning of this explicit statutory provision, the Court has considered the extent to which other provisions of the Securities Exchange Act impliedly repeal the anti-trust laws in connection with the self-regulatory responsibilities of national securities exchanges. Thus it held in Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963):

"Repeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary. This is the guiding principle to reconciliation of the two statutory schemes."

This principle is applicable, a fortiori, under Section 15A(n); and, as we show below, the Securities Exchange Act cannot be expected to work if the various district courts may render ad hoc decisions of a kind that implicitly preempt the Commission's judgment in areas of the Commission's basic regulatory responsibilities. Yet it would appear that such a result would occur if the relief requested by the plaintiff in these cases should be granted.

7/ A petition for rehearing was filed in Harwell on November 16, 1971, and the Commission on November 15, 1971, filed a brief in support of that petition. We have been informed that the court of appeals has requested the plaintiffs' views on the merits of that petition, "particularly . . . an answer to the suggestion tha language relating to the anti-trust laws be deleted from the opinion." While recognizing the authoritative impact of the decision upon district courts in this circuit, the Commission disagrees with portions of that opinion, particularly as to the anti-trust discussion involving the interpretation of Silver v. New York Stock Exchange, 373 U.S. 341, contained in Thill v. New York Stock Exchange, 433 F. 2d 264 (C.A. 7, 1970), certiorari denied, 401 U.S. 994 (1971). The Commission has no basis, however, to disagree with the language emphasized in the quotation set forth in the text.

Pursuant to Section 15A(b)(12), 15 U.S.C. 78o-3(b)(12), the Rules of the NASD must contain "provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange" Furthermore, the Commission has adopted Rule 15Aj-2, 17 CFR 240.15Aj-2, which, among other things, requires the rules of the NASD to "provide a fair and orderly procedure with respect to the determination of whether any . . . issuer . . . may be excluded or limited in respect of requested access to . . . [a] system [of securities quotations]" Rule 15Aj-2(b), 17 CFR 240.15Aj-2(b). And, "[i]n the event of any such exclusion . . . , such action shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby" Rule 15Aj-2(c), 17 CFR 240.15Aj-2(c). The Commission is required to disapprove in advance, pursuant to Section 15A(j), 15 U.S.C. 78o-3(j), any changes in the rules of the NASD that are inconsistent with certain provisions of Section 15A--including Section 15A(b)(8), 15 U.S.C. 78o-3(b)(8), which requires consideration of anti-competitive elements-- and may thereafter abrogate NASD rules when "necessary or appropriate . . . to protect investors or effectuate the purposes of . . . [the Act]," Section 15A(k)(1), 15 U.S.C. 78o-3(k)(1).

As the facts alluded to in the brief filed by the NASD in support of its motion for a stay demonstrate (n. p. 7 and accompanying text and exhibits), at every stage of the continuing development of the NASDAQ system, the NASD has amended its rules to effect each successive step and,

by filing the amendment before proceeding, has ascertained that the amendment would not be disapproved by the Commission. Moreover, on an experimental basis, a number of securities listed on exchanges which otherwise meet the NASDAQ criteria have been included in the quotation system.

The administrative oversight is actively continuing. On August 26, 1971, the Commission announced that it would hold a public investigatory hearing pursuant to Section 21(a) of the Exchange Act commencing on October 12, 1971, concerning among other matters:

"(1) The desirability, structure and means of developing a national system of securities exchanges and the relationship of such a system to other securities markets. . . .

"(5) The need for additional disclosure of information on prices, volume and quotations in all markets, and the nature thereof through a composite tape or otherwise;

"(6) Competition among exchanges and between exchanges and other markets."

The Chairman of the Commission has made it clear that the subject of those hearings encompasses the merits of inclusion or exclusion of exchange-listed securities from the NASDAQ system. See Exhibit 2 to NASD brief. And the release announcing those hearings, which is appended hereto as Exhibit A, infra, suggests the complex interrelationship between the questions framed by the complaints herein and other questions of regulatory concern that are beyond the scope of these pleadings.

Thus it appears to the Commission that an injunction that would compel inclusion of exchange-listed securities on the NASDAQ System or which would direct a change in the NASD's by-laws as to the composition of its board of directors would abrogate the Commission's oversight of the NASD and substitute the court for the Commission in deciding regulatory policy. This would occur in a context where available regulatory alternatives appear to be beyond the scope of the issues that could be presented for judicial resolution in any individual case; the proper relationship between the stock exchanges and the over-the-counter markets is an intricate question and the plaintiff in a lawsuit can present but a small part of the overall regulatory picture. Moreover, unlike issues that may be resolved in connection with less comprehensive aspects of regulatory policy, questions of the kind here involved can have no final regulatory answer: an injunction, if based upon the Commission's evaluation of present needs, would stand in the way of future review and revision that the meaningful supervision of the securities industry requires. Accordingly, Shumate's explicit request that the court direct a change in the NASD's by-laws to require that the NASDAQ System include exchange-listed securities or to modify the structure of the NASD to remedy what Shumate apparently believes to be the undue influence of exchanges in the affairs of the NASD is not susceptible to judicial solution.

Even if the Commission should ultimately accept Shumate's viewpoint and cause the NASD to disseminate quotations for listed securities on NASDAQ to the same extent as other securities and to limit participation in the NASD's affairs by exchange members, preservation of the regulatory scheme of the Securities Exchange Act compels the conclusion that the present and past actions of the NASD in these respects must be considered lawful. The rules of the NASD which relate to the matters complained of have duly been submitted to the Commission and have not been disapproved as inconsistent with the statutory mandate of the Securities Exchange Act, as would be the Commission's obligation under Section 15A(j). It may be, of course, that upon subsequent consideration the Commission may determine that a different regulatory approach is to be preferred, and may abrogate these rules pursuant to Section 15A(k)(1), 15 U.S.C. 78o-3(k)(1), as

"necessary or appropriate to assure fair dealing by the members of such associations to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this title."

But it would not follow from such abrogation that the currently-existing rules are unlawful or that the NASD or others should be subject to liability for damages. To the contrary, these rules have received implicit approval by the Commission; and any Commission decision that a change is required will reflect an administrative judgment merely that another approach is "necessary or appropriate," not that the current approach is necessarily inconsistent with the statutory objectives of the Securities Exchange Act. See Section 15A(j), 15 U.S.C. 78o-3(j).

Where rules of the NASD were filed with the Commission and have not been disapproved or abrogated by the Commission, the imposition of damages would involve substituting the judgment of the court for that of the Commission and seriously undermine the regulatory role of the Commission and the self-regulatory role of the NASD envisioned by the Securities Exchange Act of 1934. Cf. e.g., Montana-Dakota Utilities Co. v. Northwestern Public Service Co., 341 U.S. 246, 251-252 (1951). But even if, at the extreme, a rule adopted by the NASD were considered to be inconsistent with an explicit provision of the Securities Exchange Act, in this context--where the Commission has an affirmative obligation to measure the rule against statutory requirements--review should be of the Commission's failure to disapprove the rule, and the final remedy would be no more than the rule's abrogation. This is not a situation where the agency is without authority to determine the issue of violation and without power to implement its decision. Cf. Silver v. New York Stock Exchange, 373 U.S. 341, 357-359 (1963). Thus the intervention of an antitrust court is not necessary to vindicate the public interest. If a court were to impose damages against the regulated entity in such a context, meaningful Commission regulation could not survive and the regulatory scheme of the Securities Exchange Act would be destroyed.

The foregoing discussion is not to suggest that no relief is available to assure that proper legal standards have been applied to the NASD's activities. But the applicable standards are primarily those contained in the Securities Exchange Act. As we have noted above, under Rule 15Aj-2, NASD rules provide a procedure by which exclusion of the securities of any issuer from NASDAQ may be questioned, and review may be sought before the Commission by "any person aggrieved" by the decision of the NASD. Section 25(a) of the Securities Exchange Act, 15 U.S.C. 78y(a), would then authorize review of the Commission's final order in a court of appeals. Shumate has not availed itself of this procedure. Even in the absence of this specific procedure, however, under the Administrative Procedure Act, as codified:

"So far as the orderly conduct of public business permits, an interested person may appear before an agency or its responsible employees for the presentation, adjustment, or determination of an issue, request or controversy . . . in connection with an agency function."

5 U.S.C. 555. Should an interested person believe that the Commission has failed to act when required to do so, he may invoke the jurisdiction of the courts to "compel agency action unlawfully withheld or unreasonably delayed."

5 U.S.C. 706. And, in any event, under 5 U.S.C. 702:

"A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."

Proceedings brought consistent with these provisions will permit judicial oversight of the Commission's functioning in accord with doctrines that fully preserve to the agency the implementation of its statutory duties.

Furthermore, in the Commission's view, depending upon the facts that may be shown, Shumate may not be wholly without an antitrust remedy. While we believe, for the reasons indicated, that Shumate may not enjoin matters within the Commission's regulatory authority or obtain damages for acts permitted by the Commission as authorized by the Securities Exchange Act, there would be no intrusion upon the Commission and no adverse effect upon the regulatory scheme for the court to enjoin any proved conspiracy unlawful by antitrust standards and not permitted by the Securities Exchange Act. The Supreme Court has recognized that activities that are themselves lawful under a regulatory scheme may have been caused by an unlawful conspiracy, and that that conspiracy may, in fact, detract from the full effectiveness of the regulatory program. See, e.g., Georgia v. Pennsylvania R.R., 324 U.S. 439, 453-455 (1945), where the Court enjoined conspiratorial activities while holding that rates which had been approved by the regulatory commission were lawful for that reason even though they had resulted from the conspiracy. Similarly, if this Court should find conspiratorial activities as distinguished from the combinations permitted by the Securities Exchange Act, it could enjoin such activities, but not the self-regulatory decisions that have received implicit approval of the supervising agency.

All of the foregoing is entirely consistent with the Supreme Court's decisions in Silver v. New York Stock Exchange, supra, 373 U.S. 341 and other cases. Quoting Georgia v. Pennsylvania R.R., supra, the Supreme Court in Silver noted that as to "[improper collective action] over which the Commission has no authority but which if proven to exist can only hinder the Commission in the tasks with which it is confronted," 373 U.S. at 341 (brackets in original), the New York Stock Exchange had a heavy burden to justify its activity as necessary to make the Securities Exchange Act work. But in Silver the Court explicitly recognized, 373 U.S. at 360:

"Should review of exchange self-regulation be provided through a vehicle other than the antitrust laws, a different case as to antitrust exemption would be presented."

This is that different case. The activities of the NASD to which the complaint refers are, as we have shown, directly subject to Commission oversight, which has in fact been exercised. Unlike Silver, 373 U.S. at 358, therefore, the case at bar does involve a "problem of conflict or conextensiveness of coverage with the agency's regulatory powers." The authorities noted above show the approach to a proper resolution of that conflict.

Respectfully submitted,

G. BRADFORD COOK
General Counsel

DAVID FERBER
Solicitor

December 16, 1971

RICHARD E. NATHAN
Assistant General Counsel

For RELEASE Thursday, August 26, 1971

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

Securities Exchange Act of 1934
Release No. 9315

The Securities and Exchange Commission today announced that it will hold a public investigatory hearing pursuant to Section 21(a) of the Exchange Act at 10:00 a.m., October 12, 1971 at the Commission's headquarters, 500 North Capitol Street, N.W., Washington, D. C. 20549. This hearing will receive testimony and relevant data concerning the following matters:

- (1) The desirability, structure and means of developing a national system of securities exchanges and the relationship of such a system to other securities markets.
- (2) So-called "institutional membership" on exchanges including (i) exchange membership by financial institutions (such as insurance companies, trust companies, foundations, investment companies and pension funds); (ii) exchange membership by affiliates of financial institutions such as their investment advisers, managers, parents, subsidiaries or other affiliates, who may utilize such memberships, either to execute portfolio transactions for an institutional affiliate or in one way or another to facilitate the recapture of commissions by an institution or to conduct a general securities business as an exchange member, or any combination of the foregoing; (iii) exchange membership by other organizations whose primary business may not be that of a broker or dealer or their affiliates; (iv) whether and the conditions under which any of the foregoing persons should be permitted to engage in the business of a broker or dealer in securities (aside from acting as underwriters for the shares of one or more investment companies);
- (3) Restrictions on access of non-members to exchange markets and of exchange members to the third market;
- (4) The reasons for differing regulation of securities markets and the kind of additional or modified regulation, if any, which may be needed;
- (5) The need for additional disclosure of information on prices, volume and quotations in all markets, and the nature thereof through a composite tape or otherwise; and

EXHIBIT A

- (6) Competition among exchanges and between exchanges and other markets.

The facts to be adduced at the hearings with respect to the above matters would also be relevant to an understanding of the development of short-term and long-term changes in the structure of the securities markets and to the appropriate regulatory response thereto.

The Commission invites all interested persons to submit their views by means of written submissions for inclusion in the record. Interested persons may also appear at the hearings. Such persons should promptly notify the Office of the Secretary, Securities and Exchange Commission, Washington, D. C. 20549, (202) 755-1160 of their desire to appear. They should file as promptly as possible with the hearing officer a brief description in the form of an offer of proof of the scope of the evidence to be presented. The hearing officer, however, is authorized to limit presentations to written submissions whenever he deems that oral testimony would unduly delay the proceedings.

Response of New York Stock Exchange to Questions Concerning the Inclusion
of Listed Securities in NASDAQ

AUGUST 17, 1972.

Mr. JAMES J. NEEDHAM,
Chairman, New York Stock Exchange,
New York, N.Y.

DEAR MR. NEEDHAM: As you are aware, the Securities Subcommittee is currently conducting a study of the self-regulatory decision-making process. The Subcommittee has undertaken a number of case studies of issues that illustrate how this process actually operates. It is not the Subcommittee's purpose to re-examine the merits of the issues that have been decided. Rather, we are focusing on whether the processes employed were fair to all concerned.

The enclosed case study explores the decisions involved in the inclusion of listed stocks on NASDAQ. Because of your interest and involvement in this issue, the Subcommittee would appreciate your written comments on all or any of the Questions and Issues set forth at the conclusion of the study.

Please direct your response or any questions you might have regarding this case to H. Holton Wood, Jr. of the Subcommittee staff.

Sincerely yours,

HARRISON A. WILLIAMS, Jr.

NEW YORK STOCK EXCHANGE, INC.,
New York, N.Y., September 21, 1972.

Hon. HARRISON A. WILLIAMS, Jr.,
Committee on Banking, Housing and Urban Affairs,
U.S. Senate,
Washington, D.C.

DEAR CHAIRMAN WILLIAMS: As a result of a changeover in the secretarial staff in the executive offices your letter of August 17 to me was not called to my attention until today. As you know, I did not arrive on the scene until August 28 and during the transition your letter asking for our comments on the questions included in the case study on NASDAQ was misfiled. In any event, I want to apologize for the delay in responding.

As you know, I am not familiar with the New York Stock Exchange's involvement in the matters covered in the case study. From what I am told the New York Stock Exchange participation and involvement in the decision to include listed securities in NASDAQ was minimal.

However, the person on the Exchange staff who is most familiar with these matters is Donald L. Calvin. I am asking Mr. Calvin to prepare an appropriate response to the questions in the case study and you should be hearing from him direct on this shortly.

Sincerely yours,

JAMES J. NEEDHAM.

NEW YORK STOCK EXCHANGE, INC.,
New York, N.Y., November 8, 1972.

Hon. HARRISON A. WILLIAMS, Jr.,
Committee on Banking, Housing and Urban Affairs,
U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: In Chairman James J. Needham's letter to you of September 21, he said that I would be responding to you direct on the Exchange's responses to the "Issues and Questions" Section of the Subcommittee Staff's case study on the "Inclusion of Listed Securities in NASDAQ."

As the Subcommittee staff, I believe, recognizes and so indicates in the NASDAQ case study, the New York Stock Exchange's involvement in these matters was, at best, minimal. As a result, we are really not in a position to offer any input in response to the "Issues and Questions" dealing with the specific subject of the case study.

We do, however, appreciate your invitation to offer our comments and are pleased to be able to comment on the question which transcends the NASDAQ issue, that is, the first question in the case study.

This question asks:

"Are self regulatory organizations in a position to reach fair and constructive decisions on questions which involve largely economic issues between different classes of members or between members and non-members?"

I believe that the New York Stock Exchange, as a self regulatory organization, has demonstrated that it can reach fair and constructive decisions on issues coming before it. Its record, in this regard, is certainly as good as that of many government agencies, whether federal, state or local, and compares equally favorably to that of the Congress and state legislatures.

In connection with the events surrounding the decision on whether to include or exclude listed securities in NASDAQ, the Exchange approached the issue from a regulatory standpoint. As the case study accurately points out (on pages 13 and 15), the President of the Exchange wrote to the SEC asking that consideration "... be given to the regulatory problems which will arise . . ." if quotations in listed securities were included in NASDAQ. Subsequent events have demonstrated that there are regulatory problems in this area, many of which have not been resolved.

The Exchange has also had to make tough decisions on issues which were to a large degree economic, while considering the public interest and the regulatory consequences. In this regard, the Exchange is different, for example, from trade associations which often look only at the economic side of issues. A prime example of such an area is in connection with commission rates. It was the Exchange which initially advocated the position that the impact of negotiated commission rates should be carefully monitored before the breakpoint is reduced to lower levels. This position has been endorsed by the SEC, the House Subcommittee on Commerce and Finance, the Department of Justice and others.

As a practical matter, it is very difficult for any responsible organization—whether it be in the private or public sector—to make decisions which affect the economic well-being of others. In many ways, the self-regulatory organizations are better equipped to make these decisions than are government organizations. It is for this reason that you and other responsible leaders in Government frequently ask that the industry take the initiative on these issues.

In my opinion, the self regulatory organizations must respond to that call. This responsibility, so to speak, "goes with the territory."

Very truly yours,

DONALD L. CALVIN.

Response of Department of Justice to Questions Concerning the Inclusion of Listed Securities in NASDAQ

Hon. HARRISON A. WILLIAMS, Jr.,
Chairman, Committee on Banking, Housing and Urban Affairs,
U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: This is in response to your request, dated August 17, 1972, for the Department of Justice's comments on all or any of the questions and issues posed in the staff study entitled "Examination of the Decisions Involved in the Inclusion of Listed Securities in NASDAQ." This response is limited to those questions which relate to our responsibility to promote the policies of the antitrust laws in regulated industries.

Before examining the issues posed, it is appropriate to point out that the National Association of Securities Dealers (NASD) has been held to be subject to the antitrust laws unless the particular activity challenged in the antitrust case is necessary to achieve a goal of the Maloney Act, the legislation under which the NASD performs its self-regulatory responsibilities. *Harwell v. Growth Programs, Inc.*, 451 F. 2d 240 (5th Cir. 1971), *rehearing denied*, 459 F. 2d 461 (1972) *cert. den.* ---- U.S. ----- (1972). Thus the applicability of the antitrust laws to NASD activities is the same as that announced by the Supreme Court in *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963) with respect to the exchanges—activities of securities industry self-regulatory bodies are not exempt from the antitrust laws unless necessary to make the securities acts work and then only to the minimum extent necessary. See also *Thill Securities Corp. v. NYSE*, 433 F. 2d 264 (7th Cir.), *cert. den.* 401 U.S. 994 (1971).

We fully support the rationale of these cases and we will continue to be alert to anticompetitive activities engaged in by any securities industry association, including the NASD.

We turn now to the specific issues posed in the study.

1. ECONOMIC REGULATION BY SELF-REGULATORY ORGANIZATIONS

Self-regulatory organizations would not appear to be the most appropriate bodies to engage in regulation which affects vital economic interests of (i) their own members vis-a-vis non-members with whom they deal or (ii) a majority of their members vis-a-vis a minority. Self-regulation can be a useful supplement to government regulation in disciplining members for fraud and dishonest commercial activities since in such cases the interests of almost all of the members are likely to be coincident with the public interest. That coincidence of interests, however, is not so likely to exist with respect to situations involving economic conflicts between members or with non-members. See, e.g., *Rules of the New York Stock Exchange*, 10 S.E.C. 270. In such circumstances, the economic interests of the majority of members are bound to prevail and the opportunity for dissident members to compete as they wish, a right which the antitrust laws are designed to protect, is likely to be thwarted. Application of the antitrust laws to self-regulatory activities under the *Silver* doctrine serves as an indispensable restraint upon economic self-regulation designed to curtail competition rather than promote the public interest. If self-regulatory organizations in the securities industry are to continue to be permitted to engage in any form of economic regulation, continued applicability of the antitrust laws is necessary to prevent abuses of that regulation. See generally *Thill Securities Corp. v. New York Stock Exchange*, *supra*; and *Securities Industry Study: Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives* (August 23, 1972), ch. XIII.

2. THE NEED FOR MORE FORMAL SECURITIES AND EXCHANGE COMMISSION PROCEDURES

The procedures followed in the initial decision to exclude listed securities from NASDAQ as outlined in your Subcommittee study, point up a serious defect in the way competitive questions were handled by the SEC, at least at the time the decision was made. Informal procedures may be appropriate where quick action is necessary to resolve an immediate crisis in the securities markets, or where day-to-day trading activities are involved. However, considerations of fairness and thorough analysis require more open and formal deliberation when vital economic interests of firms and the investing public may be affected by a general rule of a self-regulatory organization. See *Comments of the United States Department of Justice on Proposal to Adopt Securities Exchange Act Rule 196-2*, Oct. 3, 1972; Cf. *Silver v. NYSE*, *supra*, where the denial of the opportunity to be heard was the gravamen of the offense.

It was, of course, important that the NASDAQ system be implemented as soon as possible and a long delay occasioned by public proceedings would have been unwise. However, in our opinion, in view of the competitive issues and the existence of disagreement within the industry, the better course would have been to permit the inclusion of listed securities subject to a reversal of that decision if evidence subsequently developed in public hearings indicated that inclusion threatened the public interest in the sense of impairing essential goals of the securities laws. Such a procedure would have been particularly appropriate in view of the fact that the speculative concerns over inclusion, since found to have been unwarranted, were over possible long-term effects which would not have had serious consequences during the time required for public hearings.

As indicated above, we believe that when the Commission is faced with a decision, such as the inclusion of listed securities in the NASDAQ system, it should be guided by a presumption in favor of the alternative which promotes competition. Such a general presumption in favor of competition, "our fundamental national economic policy", is mandated by the Supreme Court even in regulated industries. *United States v. Philadelphia National Bank*, 374 U.S. 321, 372 (1963), *F.M.G. v. Aktiebolaget Svenska Amerika Linien*, 390 U.S. 283 (1968); *Northern Natural Gas Co. v. F.P.C.*, 339 F. 2d 953 (C.A.D.C. 1968). Moreover, the Maloney Act, under which the NASD is regulated, imposes a requirement of competition in the over-the-counter markets (15 U.S.C. § 780-

3(b)(8)). Indeed, one of the reasons for the enactment of the Maloney Act was to encourage competition between exchange markets and the over-the-counter market. *Edison Electric Illuminating Co. of Boston*, 1 S.E.C. 909, 914-15 (1936).

Of course, if proponents of the anti-competitive course of action had subsequently been able to prove by empirical evidence that fundamental goals of the securities acts would be thwarted by the inclusion of listed securities, the presumption in favor of competition would have been overcome. In such a case, however, the decision would have been made on the basis of empirical evidence.

3. THE NEED FOR PROCEDURES WHICH WILL ASSURE AN ADEQUATE CONSIDERATION OF COMPETITIVE ISSUES IN THE SECURITIES FIELD

We have previously stated our position here and elsewhere that the SEC should adopt more formalized procedures in dealing with rules of self-regulatory organizations raising antitrust questions. See, e.g., *Comments of the United States Department of Justice, supra*. We also believe that the Department of Justice should be informed, on a more formal basis, of impending rule changes which may raise competitive problems in the securities industry. While we have had informal liaison with the SEC staff in the past, our knowledge of rule changes affecting competition in the securities industry which were not issued after public hearings has often been subsequently derived from the financial press or industry complaints. By no means do we intend to imply that the Commission is reluctant to provide necessary information when requested; and, indeed, we believe that in recent years the Commission has made a greater effort to assure that the Department knew of pending rule changes.

Congress has in various instances required a regulatory agency, before acting, to obtain a formal report from the Department of Justice on the competitive effects of a proposal submitted to it. The two most significant examples are in (i) the Bank Merger Act of 1960 (12 U.S.C. § 1828(c)) and (ii) the Atomic Energy Act of 1954 as amended in 1970 (42 U.S.C. § 2135(c)). Thus the latter requires a report from the Attorney General on the question of whether the activities involved "would create or maintain a situation inconsistent with the antitrust laws". If the Attorney General issues an adverse report, then the Commission must hold a hearing and make an antitrust finding on the application. Complete antitrust jurisdiction is also preserved for the federal courts. We do not suggest that such a procedure is necessary at this time for securities industry rules, but it should be considered if your Committee decides to require some formal notification procedure for proposed rules submitted to the SEC by the stock exchange or the NASD.

4. THE NEED FOR EFFECTIVE ANTITRUST RELIEF

Antitrust enforcement by the Department of Justice should be preserved as an effective means of preventing anticompetitive practices by self-regulatory organizations. The existence of SEC oversight neither clothes the securities industry with antitrust immunity, nor transfers primary jurisdiction from the courts to the SEC for decisions on antitrust issues. While the Commission is expert in investor protection under the securities laws, the federal courts have become the "repository of antitrust expertise." *Thill Securities Corp. v. New York Stock Exchange*, 433 F.2d at 273, and justification to decide such issues should remain with the district courts. *Securities Industry Study, supra*, pp. 164-167.

Similarly, the availability of private antitrust enforcement can have a salutary effect in forestalling unnecessarily anticompetitive regulation. It must be remembered that the *Silver* and *Thill* cases were instituted by private parties; and the threat of private suits may have compelled the NASD to reverse its exclusion of listed securities (see your Committee Study at p. 23). While issues of damages in private antitrust suits may prove a difficult problem in some instances, (see *Securities Industry Study, supra*, pp. 164-168), we believe that it can be resolved; and that the continued existence of an antitrust remedy for private parties should prove to be as effective in the securities industry as it has generally in our economy in supplementing government enforcement of those laws.

We hope these comments have been of some help to you in your study.

Sincerely,

BRUCE B. WILSON,
Acting Assistant Attorney General, Antitrust Division.

SELF-REGULATION IN THE SECURITIES INDUSTRY

WEDNESDAY, AUGUST 9, 1972

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The Subcommittee met at 2 p.m., pursuant to adjournment, in room 5302, New Senate Office Building, Senator Harrison A. Williams, Jr., chairman of the subcommittee, presiding.

Senator WILLIAMS. We will come to order. Today is the second day of our hearings on the functionings of the regulatory process in the securities industry. We are approaching our review of this process through a series of case studies. It is our hope that these case studies and the record compiled at the hearings will enable us to make specific recommendations for improvement of the procedures utilized by the self-regulatory agencies and the Securities and Exchange Commission in overseeing the activities of the securities firms.

We plan to incorporate these recommendations in the final report of the Subcommittee, which will be submitted by the end of this year. The subject of this afternoon's hearing is the case study on permitting stock exchange members to sell life insurance.

Mr. Alton Harris, Assistant Counsel, will summarize the findings of the case study made before the Subcommittee. This is the same procedure we used yesterday when we looked into another matter. I found the procedure to be helpful. It has been helpful to me and to the Committee.

Mr. Harris, would you give us the summary?

Mr. HARRIS. Thank you, Mr. Chairman. The full staff study of the decisions involved in permitting stock exchange members to sell insurance is submitted for the record. I will give only a brief summary.

Until recently member organizations of the New York and Midwest Stock Exchanges were prohibited from selling life insurance. The decisions of these exchanges to permit their members to diversify their activities into this area were important ones, carrying potentially far-reaching consequences for the manner in which the public receives financial services and the structure and regulation of interindustry competition.

This case study examines the manner in which rules of the NYSE governing the sale of life insurance by member firms were formulated, the manner in which the SEC reviewed and approved these rule changes and the contrast between the approach taken by the NYSE in this area and that taken by the MSE.

Prior to 1960, the NYSE had no rule limiting the types of activities in which a member organization could engage. It did, however, have a practice of generally limiting these activities to the securities business.

Following a study of the activities in which its members were actually engaging, the NYSE in May of 1960, adopted a policy of approving reasonable proposals of member organizations to engage, either directly or through corporate affiliates, in activities which are related to the placement and protection of financial resources.

In accordance with this policy the exchange amended its rule 318 to provide:

"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."

The amendment to Rule 318, was presented to the staff of the Commission prior to its effectiveness. No questions or objections were raised.

Rule 318, does not contain a definition of the term "kindred activities" nor does it establish criteria to be followed by the NYSE in considering whether to approve an activity which has been found to be kindred.

Decisions under the rule appear to be made largely on a case-by-case basis. As Mr. Gustave Levy, former chairman of the NYSE, stated to the subcommittee: "The term 'kindred' business as used in the NYSE Rule 318 has been the subject of ad hoc decisions by exchange staff which are not a matter of public record."

In 1965, the board of governors of the NYSE first considered the question under amended Rule 318 of whether life insurance is a kindred activity and, if so, whether it should be approved. Three member organizations had requested the NYSE to approve their plans to sell life insurance. The staff of the NYSE prepared several reports setting out the pro's and con's on the question and presented a recommendation that members not be allowed to sell life insurance.

The board of governors accepted the staff's recommendation. A circular was then issued to all members giving as the reason for the decision, the Board's opinion that: ". . . it is currently desirable in the maintenance of the quality of the service rendered by member organizations and in the surveillance procedures of the Exchange for member organizations to continue and strengthen their emphasis on securities marketing."

Prior to 1969, the MSE had also prohibited its members from selling life insurance. At that time, however, following a study by an independent consulting firm, the MSE amended its rules to permit such sales subject to a full scale self-regulatory program.

This program included exchange established training standards for salesmen and exchange established standards for the insurance companies with which members could deal. As MSE president Michael E. Tobin has stated, the exchange's goal in setting up this program was "to establish under our rules the same professional standards in the sale of life insurance that our members have been required to follow in the sale of securities."

In 1971, the NYSE again took up the question of whether member organizations should be permitted to sell life insurance. In November of that year, the staff submitted a memorandum to the board of governors recommending that such sales be "approved." The staff summarized the arguments in support of life insurance sales by NYSE member firms. These included increasing customer demand for a full range of services and the need for member firms to expand their sources of revenue. The only argument given against permitting mem-

bers to sell life insurance was that it might cause increased pressure from the life insurance companies to gain exchange membership—that is, institutional membership. The staff made no reference to the reasons for the board's 1965 decision to prohibit the sale of life insurance.

Based on the staff's recommendation, the NYSE Board voted to "approve" the sale of life insurance. In doing so, it rejected, however, the idea of establishing a regulatory program similar to the MSE's, apparently on the grounds that the staff was not equipped to regulate insurance activities and that it is questionable "whether the exchange should attempt to regulate a nonsecurities activity which is already subject to extensive regulation by State authorities."

Under Rule 318, the board could "approve" insurance sales without the need for a vote of members. Comments on the insurance proposal were not solicited from members of the public generally.

Shortly after the board's action in November 1971 the New York Stock Exchange filed with the SEC "implementing rules under which member organizations may engage in the sale of life insurance." The staff of the Commission's Division of Trading and Markets, replied approximately 3 weeks later. The SEC did not raise any questions concerning the fundamental policy change involved in allowing NYSE member organizations to sell life insurance. It focused attention instead on the NYSE plans for regulating such sales and asked the NYSE to comment "on the reasons you believe that the manifold State requirements are a desirable substitute for uniform exchange entry standards. . . . and to inform us of the program, including, standards of conduct, which you are developing to regulate insurance sales by your members."

The SEC forwarded a copy of its letter to the MSE with a request for its comments. No other organizations were asked to comment, and the NYSE's filing was not made public.

A week later the NYSE replied to the SEC's letter stating that the NYSE believed that by requiring all persons selling insurance to meet exchange standards as to training and examination of securities salesmen as well as to satisfy state insurance requirements, the NYSE was providing adequate regulation.

The SEC replied by advising the NYSE that its letter was "not sufficiently responsive" to the SEC's questions to enable the staff to satisfactorily comment on the NYSE's proposal to permit member firms to sell life insurance.

The NYSE wrote again in January of 1972 "to expand" its reply to the SEC's questions. In response to the SEC's suggestion in the preceding letter that the NYSE adopt a regulatory program similar to Midwest's, the NYSE stated: "We believe the Commission should satisfy itself that the sale of life insurance without a program of the type described by the Midwest Stock Exchange is consistent with the public interest. We believe that it is."

On February 1, 1972, the SEC wrote to the NYSE, stating that the Commission believed "an adequate self-regulatory program should be presented before the Exchange permits its members to proceed with this new activity." The SEC indicated that it did not believe the New York Stock Exchange had, as yet, presented such a program.

Following this letter there was a meeting between the staffs of the SEC and the NYSE. Shortly thereafter, in March of 1972, the NYSE board of governors gave its "final approval" to various rule

amendments in connection with the life insurance program. These amendments included the rules which were originally filed with the SEC the preceding November together with new requirements dealing with information to be filed by members with the exchange. The amendments did not provide for exchange-established training standards for registered representatives selling life insurance or for exchange-established standards to help assure that the insurance companies with which member organizations dealt were of a high degree of financial responsibility—key elements in what the Commission had described as an “adequate self-regulatory program.”

These NYSE rule amendments were filed with the SEC on March 21, 1972. The SEC's final comment was given shortly thereafter. The SEC stated: “We have previously communicated to you our belief that it is in the Exchange's interest that member firms conduct insurance operations so as not to affect adversely their responsibilities to the public respecting their securities business. Accordingly, we have no further comment on the proposed amendments.”

The NYSE began permitting members to sell life insurance on April 5, 1972.

That concludes the summary of the case. The questions and issues which the case raises are included at the end of the full study.

Senator WILLIAMS. Thank you very much, Mr. Harris.

(The complete case study on life insurance sales follows:)

STAFF STUDY OF THE DECISIONS INVOLVED IN PERMITTING MEMBER ORGANIZATIONS OF THE NEW YORK AND MIDWEST STOCK EXCHANGES TO SELL LIFE INSURANCE*

The first report of the Securities Industry Study of the Senate Subcommittee on Securities recognized the existence of certain limitations in the methods and concept of self-regulation.¹ As a means of providing insight into the decision-making process within the self-regulatory agencies and the manner in which public supervision and control over these agencies is conducted by the Securities and Exchange Commission (“SEC”), the staff of the Subcommittee has undertaken a series of case studies focusing upon particular policy decisions by the self-regulatory agencies and the manner of their review by the SEC.

The following case study examines the manner in which rules of the New York Stock Exchange (“NYSE”) governing the sale of life insurance by member firms were formulated, the manner in which the SEC reviewed and approved these rule changes and the contrast between the approach taken by the NYSE in this area and that taken by the Midwest Stock Exchange (“MSE”). The focus of the study is on the NYSE. This is not because its regulatory procedures are better or worse than other self-regulatory agencies, but because it is the dominant institution in the entire scheme of self-regulation.²

BACKGROUND

Prior to 1960, the NYSE had no rule limiting the types of businesses in which a member organization could engage. It did, however, have “a practice” of so limiting the activities of member organizations and their affiliates. In 1958, the NYSE member firm of A. G. Edwards & Sons requested the Exchange to approve its formation of a corporate affiliate to engage in the sale of life insurance. The NYSE Board of Governors in accordance with the “practice” denied the request, stating: “It is the policy of the Exchange not to approve corporate affiliates unless their activities are in the securities or commodities business.”

The Edwards application was a harbinger of the diversification of member firms that was to occur in the 1960's. Apparently recognizing the emergence of this trend, the NYSE sought to develop a policy with respect to member firm

*This case study is based on both public and confidential records of the exchanges and the SEC Citations are given only to public records.

¹ Senate Comm. on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess., Report of Subcomm. on Securities at 73 (Comm. Print 1972).

² *Id.* at 74-75.

expansion into areas other than stocks, bonds and commodities. In 1959 and 1960, the Exchange conducted a comprehensive study of the activities in which its member firms were engaging. The study disclosed an increasing tendency of member firms to diversify the range of services they were offering to the public.³

In an apparent response to the results of the study and a growing recognition in the member firm community of the "advantages" of diversification, in May of 1960 the Exchange adopted a policy of approving "reasonable" proposals of member organizations to "engage, either directly or through corporate affiliates, in activities which are related to the placement and protection of financial resources." In accordance with this policy the Exchange amended Rule 318, effective May 2, 1960, to provide: "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".⁴

The amendment to Rule 318 was presented to the staff of the Commission approximately ten days prior to its effectiveness. The staff had no questions or objections to the amendment.

The purpose of Rule 318 appears to have been to formalize exchange policy requiring member organizations to have the securities business as their principle activity and, while indicating that a degree of diversification was acceptable, to make clear that member organizations "are expected to give the Exchange their primary loyalty." The materials on the rule filed with the Commission and distributed to members did not contain a justification of the prohibition against member firms engaging in activities which are not "kindred" to the securities business, or an explanation of the need for Exchange approval before members may engage in activities which are "kindred." Neither the rule nor the accompanying material define the term "kindred" or establish criteria to be followed by the Exchange in considering whether to "approve" an activity which has been found to be "kindred."

Under Rule 318, decisions are made on a case-by-case basis. A member organization wishing to engage in an activity other than the buying or selling of securities or commodities files an application with the Exchange. The staff reviews the application to determine if the proposed activity falls within what it considers to be the "interpretive guidelines" laid down by the Board of Governors in prior decisions. If the activity comes within the guidelines, the staff approves the application. If it does not, either because the activity is believed not to be "kindred" or because it has not previously been approved, the staff will deny the applications subject to the member's right to bring the matter before the Board.

The decisions of the Board of Governors and the staff on the applications made under the rule are filed with the records of the member making the application, not in a single or subject matter file. There is no statement or summary available of the "interpretive guidelines" on the basis of which applications are processed. Exchange decisions on Rule 318 applications are not made public or filed with the Commission. (Mr. Gustave Levy, former Chairman of the NYSE, has recently stated to the Subcommittee: "The term 'kindred' business as used in the NYSE Rule 318 has been the subject of ad hoc decisions by Exchange staff which are not a matter of public record.")⁵

1965 NYSE DECISION ON LIFE INSURANCE SALES

The Board of Governors did not vote on the status of life insurance sales under Rule 318 until 1965. During the period between the adoption of the rule and the Board vote, the NYSE staff examined the question in a series of internal memoranda.

As early as 1961, the staff appears to have taken the position that Rule 318 "clearly contemplates including life insurance within the related fields that members may engage in," and, indeed, had been "specifically designed to embrace . . . life insurance." The staff recognized, however, that there were important considerations on both sides of the question of whether the sale of life insurance should be "approved."

³ Among the activities in which member organizations were engaging were: leasing and operating grain elevators, arranging collateral, making mortgage and insurance loans, acting as financial advisor to corporations, performing management consultant services, acting as real estate brokers, and counseling on stockholder relations.

⁴ Rule 318 was further amended in March 1970 and now provides: "The primary purpose of every member organization . . . shall be the transaction of business as broker or dealer in securities. With the prior approval of the Exchange, member organizations may engage in any activities kindred to the securities business."

⁵ Levy, responses to question 7 of the Subcommittee's institutional membership questionnaire.

The arguments for permitting life insurance sales included :

1. It would enable a single organization—i.e., the member firm—to handle more of an individual's financial matters.
2. It would assist member firms to increase their earnings potential.
3. Life insurance being supplementary rather than competitive with securities investments, the sale of life insurance would be a natural means for member firms to diversity.
4. The securities and insurance businesses are closely allied, particularly in light of the Supreme Court decision that a variable annuity is a security.
5. By selling insurance, member firms could develop reciprocal business with insurance companies.

The arguments against permitting life insurance sales included :

1. Expansion into life insurance sales might divert the primary attention of member organizations and their registered representatives away from the securities business, resulting in a decline in professional standards.
2. Member firms and the Exchange would become subject to a new group of regulatory requirements and agencies.
3. Registered representatives would be required to learn a new business of substantial complexity and with a high degree of regulation.
4. The Exchange would have to assume a degree of responsibility—of some sort—for assuring that salesmen carried out their obligations under applicable regulations and professional standards.
5. Large life insurance companies—many of which were substantial customers of NYSE member organizations—would resent the intrusion into “their” business and develop an antagonistic attitude toward the NYSE.
6. Member firm sales of life insurance might be a step in the direction of Exchange membership by organizations which are primarily insurance companies, i.e., institutional membership.

During the latter part of 1964 three member organizations (Dempsey-Tegeler & Co., Inc., D. H. Blair & Company and Janney, Battles & E. W. Clark, Inc.) requested the Exchange to approve proposals to sell life insurance. On November 5, 1964 members of the Board of Governors of the NYSE were sent a “draft memorandum” from the staff concerning these applications and the broader implications of permitting member organizations to sell life insurance. The replies from the Governors “persuaded” the staff that the issue “needed further investigation.” On April 2, 1965 the members of the Board were sent a revised version of the memorandum describing the proposals of the petitioning member firms, summarizing the arguments pro and con, and recommending that member organizations “not be permitted to engage in the sale of life insurance.” On June 10, 1965 the final version of the memorandum containing the same recommendation was sent to the Advisory Committee.

On June 16, 1965 the Advisory Committee considered the staff memorandum concerning the policy of the exchange toward the sale of life insurance by member organizations and recommended to the Board that such sales be prohibited. The Board approved the recommendations the following day.

The firms applying for permission to sell life insurance were notified of the Board's decision and told that the conclusion was :

... based on a belief that specialization of Exchange firms is largely responsible for the breadth of American shareownership and the health of American capital markets, and that continued specialization is desirable in the maintenance of the quality of the service rendered by member firms and in the surveillance of member organizations by the Exchange. An Educational Circular to be published in the near future will announce the decision.

On July 28, 1965 the NYSE issued a circular to all members stating :

The Board of Governors recently reviewed the request of several member organizations who desired to engage in the sale of life insurance. The Board was of the opinion that it is currently desirable in the maintenance of the quality of the service rendered by member organizations and the surveillance procedures of the Exchange for member organizations to continue and strengthen their emphasis on securities marketing. The requests to enter the insurance sales field were therefore denied.⁹

The NYSE sent a copy of the circular to the Commission, but made no official filing with the Commission under Rule 17a-8 or otherwise because it believed

⁹ NYSE MF Educational Circular, July 28, 1965.

"no decision was taken to change any rule or stated policy of the Exchange in this matter."

1969 MIDWEST STOCK EXCHANGE DECISION ON LIFE INSURANCE SALES

Prior to 1969, member organizations of the MSE were prohibited from selling life insurance. Rule 2 of Article XVI of the MSE Rules provided that all registered representatives of member organizations "must devote full time to the securities business." The Exchange could disapprove any "incidental" or "supplementary" employment.

In June of 1968, the MSE sent a letter to a cross-section of its membership soliciting their views on the desirability of permitting member organizations to sell life insurance. Although the survey's "results were fairly inconclusive," the MSE was reportedly "constantly" receiving inquiries from its smaller members on the subject. On March 11, 1969 the Board of Governors engaged an independent consulting firm to conduct a two-phase study to determine whether and, if so, under what conditions member firms should be able to sell life insurance.

On June 17, 1969, the consulting firm presented to the MSE Board of Governors the findings of the first phase of its study concerning the feasibility of members engaging in the life insurance business. The Board then :

... approved the concept of member firms being permitted to engage in the sale of life insurance. The staff was directed to advise the membership of the thinking of the Board, and the fact that a second phase was under way to establish the standards and structure for selling life insurance within member firm organizations.

On October 6, 1969, the Board's Executive Committee approved a new Article XXXI to the MSE rules, permitting member organizations to sell life insurance. The Board of Governors approved the new rules the next day and directed the staff to provide a full explanation of the insurance program to be implemented under the rules to the MSE membership.

The insurance program that was adopted by the MSE requires member firms to obtain Exchange approval of the "plan" under which they will sell life insurance, to file periodic reports with the Exchange describing their insurance transactions and to qualify all salesmen with the Exchange through an approved training course or a MSE-approved examination.⁷ According to MSE President Michael E. Tobin, the Exchange's "goal" is "to establish under our Rules the same professional standards in the sale of life insurance that our members have been required to follow in the sale of securities."

On October 8, 1969, the MSE filed with the Commission the new Article XXXI to its Rules captioned "Life Insurance as an Ancillary Activity." The MSE stated: "The purpose of this new Article is to provide the means by which member organizations will be able to offer customers life insurance in a program of full financial services."⁸ The MSE did not file with the Commission an explanation or description of the regulatory program it intended to establish to oversee life insurance sales. In a letter dated November 5, 1969, the Commission advised the MSE that it had no comments with respect to the Exchange's proposal except the following: "We assume the Exchange will continually re-evaluate procedures for supervising those salesmen who will be selling life insurance with a view to providing adequate regulation and supervision of such employees, all in accordance with the Exchange's responsibility to fulfill its self-regulatory duties."⁹

On October 14, 1971, the MSE filed with the SEC modifications to Article XXXI broadening the Exchange-established qualification requirements for persons engaged in the solicitation and sale of life insurance policies, and adding a new requirement that all persons selling insurance be licensed in the states in which they operate.¹⁰ In a letter dated November 8, 1971, the Commission indicated it had no comments on the proposed amendments.¹¹

On February 17, 1972, the MSE filed with the Commission additional amendments to its rules "codifying" many of its regulatory practices relating to the

⁷ For a fuller description of the program see MSE Rules 1, 2 and 3 of Art. XXXI, and letter from Lawrence V. Conway, Vice President, MSE, to Sheldon Rappaport, Associate Director, Div. of Trading and Mkts., SEC, Dec. 7, 1971.

⁸ Letter from Frank J. Rothing, Senior Vice President and Treasurer, MSE, to Irving M. Pollack, Director, Div. of Trading and Mkts., SEC, Oct. 8, 1969.

⁹ Letter from Sheldon Rappaport to Frank J. Rothing, Nov. 5, 1969.

¹⁰ Letter from Lawrence V. Conway to Irving M. Pollack, Oct. 14, 1971.

¹¹ Letter from Martin Moskowitz, Assistant Director, Div. of Trading and Mkts., SEC, to Lawrence V. Conway, Nov. 8, 1971.

sale of life insurance.¹² Included among the Exchange rule changes were an enumeration of permissible and prohibited trade practices in the sale of life insurance and the articulation of the MSE's criteria for approving the insurance carriers with which its members can deal. The SEC stated it had no comments on these proposed amendments.¹³

1971 NYSE DECISION TO PERMIT LIFE INSURANCE SALES

The question of whether NYSE members should be allowed to sell life insurance came before the Board of Governors again in early 1971. By this time, the MSE was able to report considerable success with its program, stating that its member organizations had during the first year of the program's operation sold more than \$255 million of face-value life insurance. (It should be noted that with the overlapping jurisdiction of the various self-regulatory agencies, a member of the NYSE is, as a general rule, subject to the rules of that exchange regardless of the differing rules of other exchange of which it may be a member. In this case, therefore, the MSE's rules permitting members to sell life insurance affected only those members which were not also members of the NYSE. MSE-only members thus had, or so it was argued, a competitive advantage over firms which were members of the NYSE.)

On January 7, 1971, the Association of Stock Exchange Firms ("ASEF") wrote to the NYSE Board of Governors urging action to permit the sale of life insurance by NYSE member organizations. The ASEF enclosed an October 1970 memorandum from its Committee on Life Insurance Sales setting forth arguments in favor of life insurance sales by member firms. The memorandum, which was based on a three-year study by the ASEF Committee, cited increasing customer demand for a full range of financial services and the need for NYSE member organizations to locate new sources of income, to diversify their public services and to compete effectively for customer dollars and capable sales personnel. The ASEF also noted that MSE member firms had been permitted to sell life insurance and pointed out that the 1969-1970 securities industry recession emphasized the need for member firms to find new sources of income and to diversify.

Although the ASEF proposal was originally scheduled to be considered shortly after its submission, the Board of Governors decided to postpone its consideration, apparently on the ground that "... consideration of the sale of life insurance should be deferred until the larger question of institutional membership has been resolved, so that the decision on life insurance can be consistent with whatever position is taken on institutional membership."

By November 1971, however, growing member firm pressure and the unfavorable economic condition of the member firm community forced the Board to take up the life insurance question even though the institutional membership question remained unresolved.

On November 9 and November 16, 1971, the Department of Member Firms forwarded to the Advisory Committee memoranda recommending that the Committee approve in principle Exchange rule amendments to permit the sale of life insurance by persons qualified to sell securities. The memoranda outlined the Exchange's previous decisions on the life insurance question, summarized the ASEF's findings and recommendations and described the manner in which the MSE had implemented its life insurance sales program. In addition to presenting the ASEF's arguments in support of life insurance sales by NYSE member firms, the staff noted that financial organizations such as banks and insurance companies had diversified their activities in recent years, thereby providing increased competition to NYSE member firms. The only argument the staff presented against permitting members to sell life insurance was that it might cause increased pressure from the life insurance companies to gain Exchange membership.

No reference was made in either memorandum to the reasons for the Board's decision in 1965 to prohibit the sale of life insurance or to its conclusion at that time that "... it is currently desirable in the maintenance of the quality of the service rendered by member organizations and in the surveillance procedures of the Exchange for member organizations to continue and strengthen their emphasis on securities marketing."

The November 9 memorandum included the following comment:

The Exchange, of course, has a duty to enforce insofar as practical its Constitution and Rules. One of the basic objectives of the Exchange Constitution and Rules, and of the Securities Exchange Act of 1934 as

¹² Letter from Lawrence V. Conway to Irving M. Pollack, Feb. 17, 1972.

¹³ Letter from Martin Moskowitz to Lawrence V. Conway, March 27, 1972.

well, is to maintain high standards of commercial honor and integrity among members and to promote just and equitable principles of trade and business. Many of the Exchange rules are aimed at meeting these objectives. It would seem that fraudulent or other improper activity on the part of member organizations would be in violation of these concepts even though the improper activity concerned the sale of insurance rather than securities. Failure of the Exchange to enforce its rules where it knew or should have known of the improper activity could give rise to legal liability on the part of the Exchange. However, this situation already exists with respect to member organization activities in other non-securities area [sic]; for example, commodities and real estate syndication activity. Experience in these non-securities areas has not shown any serious exposure. The staff's inquiries into the sale of life insurance does not indicate that this activity should be expected to give rise to significant potential exposure to the Exchange.

The memorandum then outlined three possible approaches the NYSE could take toward regulating sales of life insurance by its members: (1) follow the approach taken by the MSE, (2) exercise no regulatory oversight and (3) adopt a "middle course."

The NYSE staff recommended rejecting the approach taken by the MSE to the regulation of life insurance sales by member firms. Among the reasons given were:

[T]he Exchange staff is not today equipped to regulate insurance activity. Further, there is a question as to whether the Exchange should attempt to regulate a non-securities activity which is already subject to extensive regulation by state authorities. In addition, it is doubtful that Exchange member organizations want or need the kind of counseling offered by the MSE to its members.

The staff also recommended against permitting member firms to sell life insurance "without qualification or limitation of any kind", since "it does not appear to be an appropriate initial posture in the absence of any experience."

As a compromise, the NYSE staff presented a third approach, based on a requirement that life insurance could be sold only by persons who are qualified NYSE registered representatives and have been licensed under applicable insurance laws. In favor of this course of action the Department of Member Firms argued:

1. It would provide a standard which would be required of member firm personnel without incurring the expense and expanding the effort necessary to provide the regulatory and counseling structure provided by the MSE;
2. It would extend to those who sell life insurance the same standards required for NYSE approval of registered representatives, including the requirement that they be full time employees of their member organizations;
3. It would assure that any individual selling life insurance would have at least a minimal knowledge and appreciation of the securities business and its products; and
4. It would fit into the plans of most member firms to offer life insurance by their present registered representatives.

On November 17, 1971, the Advisory Committee considered the staff memoranda and recommended that the Board of Governors approve "in principle" amendments to certain Exchange rules to permit the sale of life insurance. This recommendation was approved by the Board of Governors the following day.

Because Rule 318 permitted the Board to "approve" kindred activities, member organizations could be permitted to sell life insurance without a vote of the membership on the issue. No effort was made to solicit comments on the proposal from members or the public generally.

In announcing the Board's decision on November 18, NYSE President Robert W. Haack stated: "Investor needs have changed, and the demand is growing for a wider range of financial services available at one source."¹⁴ Mr. Haack also noted a need to diversify member firms' sources of income in the face of rising costs and the cyclical nature of the securities business. He did not mention the arguments against allowing securities firms to sell life insurance nor did he explain—other than pointing to the "needs" of investors and member firms—why the Board had reversed its 1965 decision.

¹⁴ NYSE Press Release, Nov. 18, 1971.

SEC REVIEW OF NYSE LIFE INSURANCE PROPOSALS

On November 19, 1971, the NYSE filed with the SEC, pursuant to Securities Exchange Act Rule 17a-8, "implementing rules under which member organizations may engage in the sale of life insurance."¹⁵ These proposed rules took the form of amendment to Exchange Act Rule 311 (requiring a member, allied member, approved person or member organization to report to the Secretary of the Exchange if it became the subject of certain specified legal actions), Rule 318.13 (permitting member organizations to sell life insurance "only through members, allied members or registered representatives who meet the licensing or other requirements of applicable insurance laws"), Rule 345.17 (H) and (I) (requiring registered representatives and officers to agree to accept compensation in connection with insurance transactions only from their member organization and to report to the member organization and the Department of Member Firms if they become the subject of certain specified legal actions) and Rule 351 (requiring an employee of a member or member organization to report to his employer if he has been or becomes the subject of certain specified legal actions).

The NYSE justified the proposed rules as follows:

A decision to permit member organizations to sell life insurance is primarily based on the increasing demand of customers for a full-range of financial services, the need for member organizations to diversify their sources of income in the face of rising costs and the cyclical nature of the securities business, and the increasing competition for savings dollars and competent salesmen.¹⁶

The materials filed with the Commission did not contain an explanation of the NYSE's plans for regulating life insurance sales. The NYSE's position at the time, however, was that: "... we do not plan to take an active role in the regulation of life insurance as we consider it appropriate to defer it to the experts in the field that is the various state insurance commissioners."

On December 3, 1971, Sheldon Rappaport, Associate Director of the Commission's Division of Trading and Markets, replied to the NYSE 17a-8 filing. Rappaport did not raise any questions concerning the fundamental policy change involved in allowing NYSE member organizations to sell life insurance. He focused instead on the NYSE plans for regulating such sales.

The Exchange, as part of its self-regulatory responsibilities, requires securities salesmen to have a minimum standard of knowledge about securities laws and Exchange rules for the protection of investors. The investing public has come to expect, and the Exchange and its members advertise, that dealing through an Exchange member helps assure high standards of ethical business conduct and knowledge. We would anticipate similar reliance by the public in the case of life insurance sales by registered representatives of member firms.

In light of the above, would you comment on the reasons you believe that the manifold state requirements are a desirable substitute for uniform Exchange entry standards . . . and inform us of any program you may have to insure that persons selling both insurance and securities are qualified advisors.

With regard to continuing regulation of insurance sales, you state that since individuals who sell life insurance must also be qualified to sell securities, such persons will be subject to the investigative and other qualification requirements and other rules governing conduct as apply to members and registered representatives. We do not understand from this the extent to which the Exchange plans to regulate the insurance sales practices of these persons. Would you please inform us of the program, including standards of conduct, which you are developing to regulate insurance sales by your members.¹⁷

Rappaport also asked for an explanation of the record keeping requirements the Exchange would establish to reflect policies sold through member firms and the compensation received by member firms or their registered representatives, the safeguards the NYSE would erect to prevent undesirable insurance practices such as "twisting" (i.e., improperly advising a customer to replace an

¹⁵ Letter from David D. Huntoon, Assistant Vice President and Associate Director, NYSE, to Irving M. Pollack, Nov. 19, 1971.

¹⁶ *Id.*

¹⁷ Letter from Sheldon Rappaport to David D. Huntoon, Dec. 3, 1971.

existing policy with a new one) and the methods the Exchange would employ to prevent improper representations to induce life insurance sales.

As previously noted, the MSE's approach to the regulation of the sale of life insurance by its member organizations was substantially different from that proposed by the NYSE. Apparently because of this difference, the Commission felt it would be valuable to obtain the MSE's reaction to the NYSE's proposal. Accordingly, a copy of Rappaport's December 3 letter was forwarded to the MSE with a request for its comments. No other organizations were asked to comment, and the NYSE's filing was not at this time made public.

On December 10, 1971, Lee D. Arning, Senior Vice President of the NYSE, replied to Rappaport's December 3 letter. In response to the major issue raised by the SEC—the need for exchange established standards and regulations—Arning stated:

First let me say that prior to adopting these rules the Exchange carefully considered questions similar to the ones raised in your letter. It was because of these concerns that it was decided that no person could engage in the sale of life insurance with a member organization unless he first had been thoroughly investigated and had met the Exchange standards as to training and examination applicable to members, allied members and registered representatives. In effect, this means that those who sell insurance through our member organizations must meet the standards of the Exchange plus the appropriate state standards—albeit a double standard.¹⁸

Arning went on to state that the NYSE did not foresee the need for additional record keeping requirements "other than memorandum records for such purposes as the firms may desire" and that the Exchange had been informed "that the major states (in population and insurance sales) have specific requirements with respect to disclosure when one policy is being sold to replace another" which would prevent the practice of "twisting". He concluded: "We trust that this letter answers your questions and will enable you to give us a response in time for our Policy Meeting on December 16th."

On December 16, 1971, Rappaport advised Arning that the NYSE's December 10 letter was "not sufficiently responsive to the questions in our letter of December 3, 1971 to enable us to satisfactorily comment on your proposal to permit member firms to sell life insurance. You indicate that you recognize the need for continuing oversight and review of member organization's experience in the sale of life insurance, but you have not at this time developed any specific regulatory program to qualify persons to sell life insurance or to regulate this activity. We see no objection to your members undertaking this new activity, but our concern is with the accompanying oversight program which may be required."¹⁹

Rappaport called attention to a letter from the MSE dated December 7, 1971, commenting on the NYSE's proposal and outlining the MSE's insurance regulatory program. "As you will see, that exchange deemed it essential for their proper regulatory control to require successful completion of their training program before their member personnel can sell life insurance."

On January 7, 1972, Arning wrote "to expand" the NYSE's reply to Rappaport's question and request his "final comments."²⁰

In the period of several years in which the question of the sale of life insurance by member organizations was examined, considerable background work has been performed. For example, discussions have been held with major insurance companies, prime general agents and with Insurance Commissioners. In this period we have learned much, and if our advisors have the knowledge that we believe them to possess, the sale of life insurance by our members should not present unusual regulatory problems.

Arning went on to state: "We conclude that a very substantial investment will be made in the member community by both the insurance companies and our members to develop a fully skilled insurance sales force." "We believe the training requirements, supervision and overall financial expertise developed by quali-

¹⁸ Letter from Lee D. Arning, Senior Vice President, NYSE, to Sheldon Rappaport, Dec. 10, 1971.

¹⁹ Letter from Sheldon Rappaport to Lee D. Arning, Dec. 16, 1971.

²⁰ Letter from Lee D. Arning to Sheldon Rappaport, Jan. 7, 1972.

fied registered representatives of this Exchange prepare these persons in a general way to sell insurance."

As for the MSE's position, the NYSE commented as follows:

With regard to the letter you received from the Midwest Stock Exchange in response to your solicitation, we do not disagree with the stated objectives of their rules relating to the sale of life insurance. The protection of public customers and the elevation to the level of competence of securities salesmen are certainly laudable goals, and any steps which materially advance us toward them are certainly justified.

However, the establishment of valid goals is not in and of itself sufficient to justify the establishment of rules by a self-regulatory body. Those rules must stand on their own feet, in that they must be demonstrably necessary and effective. We are not convinced that the rules established by the Midwest Stock Exchange meet this test. As noted above, we believe the Commission should satisfy itself that the sale of life insurance without a program of the type described by the Midwest Stock Exchange is consistent with the public interest. We believe that it is.

Arning closed by requesting the SEC's further comments in time for the Policy Board Meeting on January 20, 1972.

Rappaport responded to the NYSE's January 7 letter on February 1, 1972, reiterating that the Commission had no objection "in principle" to the sale of life insurance by NYSE member firms. He went on to state that the Commission believed "that an adequate self-regulatory program should be presented before the Exchange permits its members to proceed with this new activity."²¹ Such a program would include: "Exchange established training standards insuring a uniform minimum level of expertise, rules requiring adequate recordkeeping to facilitate Exchange surveillance, and uniform standards designed to help assure financial responsibility of insurance companies whose policies your members will sell." Rappaport offered the assistance of the SEC staff in the development of the NYSE program.

On February 8, 1972, Arning sent a memorandum to the Advisory Committee on the question of whether the NYSE should "establish a program for regulation of life insurance by member organizations." He pointed out that "in recognition of the extensive state regulation of life insurance, [the Exchange had decided] not to involve itself in regulation aspects of the sale of life insurance." He then went on in referring to the SEC's February 1 letter to state:

An extensive self-regulatory program appears to be the Commission's direction—modeled in part at least on the views of the Midwest Stock Exchange. Since the New York Stock Exchange has no expertise in this area, assistance and personnel would have to be acquired. This aspect was recognized in the initial Board of Governors review, and the decision was made at that time that this route was not desirable.

Without making a recommendation, Arning posed the following question for discussion: "In view of the SEC response to the proposed rule changes—should the Exchange develop a self-regulatory life insurance program?"

On February 17, 1972 Arning sent a proposed revision of Rule 318.13 to the Board of Governors. He stated: "Preliminary discussions yesterday with Mr. Rappaport indicate that the rule draft appears generally satisfactory to him, but must, of course, be cleared with the Commission.

Under the revised rule, every member firm would be required to maintain a file available for Exchange inspection, describing its supervisory and surveillance program for insurance sales and disclosing its sales record. In addition, member firms would be required to report to the NYSE the name of each person through whom the firm sells insurance, the training received by each salesman, every state in which each salesman is licensed to sell insurance and the names of the life insurance companies which each salesman is licensed to represent. The revised rule did not provide for Exchange-established training standards for registered representatives selling life insurance or for Exchange-established standards to help assure that the insurance companies with which member organizations dealt were of a high degree of financial responsibility.

On March 16, 1971, the Advisory Committee recommended that the Board of Governors give "final approval" to the various rule changes that had been proposed in connection with the life insurance program, including the February 17

²¹ Letter from Sheldon Rappaport to Lee D. Arning, Feb. 1, 1972.

revision of Rule 318.13. The Board approved the recommendation the following day.

The "series of rule changes to accomplish the permissive sale of life insurance" was filed with the SEC on March 21, 1972 together with a draft of the circular describing the program which was to be distributed to members.²² On March 29, 1972, Rappaport replied to the March 21 filing as follows: "We have previously communicated to you our belief that it is in the Exchange's interest that member firms conduct insurance operations so as not to affect adversely their responsibilities to the public respecting their securities business. Accordingly, we have no further comment on the proposed amendments."²³

The NYSE's life insurance program, as filed with the SEC on March 21, 1972, went into effect on April 5, 1972.

QUESTIONS RAISED BY SENATOR HARRISON A. WILLIAMS, JR., REGARDING THE NYSE PROPOSAL

On November 23, 1971, four days after the proposed rule modifications had been submitted to the SEC, Senator Harrison A. Williams, Jr. (D-N.J.), wrote to Ralph D. DeNunzio, Chairman of the Board of the NYSE, raising several basic issues about the policy implications of the Board of Governors' decision to permit the sale of life insurance by member firms.²⁴ Among other matters, Senator Williams posed the following questions:

1. Would the NYSE permit member firms to enter into arrangements to market the policies of only one life insurance company, and, if so, would these arrangements conflict with a member firm's obligation to recommend the best investment to its customers?

2. Would the NYSE approve of a member firm acting exclusively for a particular insurance company in the purchase and sale of securities?

DeNunzio replied to Senator Williams' questions on December 16, 1971.²⁵ He stated that the Exchange did not plan to concern itself with whether member organizations marketed the policies of only one life insurance company. "[S]uch arrangements are entered into by securities firms with respect to the shares of one mutual fund or group of funds. We assume that if this practice were questionable with respect to the sale of mutual fund shares it would have been the subject of a ruling by the SEC or other securities regulatory authorities."

As for the Senator's second question, DeNunzio stated that the NYSE had no objection to a member firm acting as sole agent for an insurance company in the purchase and sale of securities. He indicated that the NYSE expected such relationships to develop between those member organizations and insurance companies which establish an exclusive arrangement with respect to the sale of life insurance, and saw "no inherent evil in this tendency."

On February 8, 1972, Senator Williams again wrote to DeNunzio to express his concern over the NYSE's view that insurance companies would probably give their brokerage business to those member firms which sell their life insurance and that there was "no inherent evil in this tendency."²⁶ He pointed out that the SEC, in its recent statement on the future of the securities markets, had strongly condemned the use of reciprocal portfolio brokerage to reward brokers for selling mutual fund shares.

I assume that, in light of this policy determination by the Commission, the Exchange will now re-examine its position with respect to the anti-competitive reciprocal relationships with life insurance companies, and will consider how such reciprocal arrangements could be effectively prohibited in the event it is decided to go ahead with the plan to permit member firms to sell life insurance.

DeNunzio replied on February 18, 1972, stating:

The staff of the Commission has pointed out the question of portfolio commissions in this area, noting the Commission's comment recently in the mutual fund area. We are discussing with them how this will be handled, and I believe we will provide comment on this point in our announcement circular when and if our Board approves the sale of life insurance.²⁷

²² Letter from Lee D. Arning to Sheldon Rappaport, March 21, 1972.

²³ Letter from Sheldon Rappaport to Lee D. Arning, March 29, 1972.

²⁴ Letter from Senator Harrison A. Williams, Jr., to Ralph De Nunzio, Chairman of the Board, NYSE, Nov. 23, 1971.

²⁵ Letter from R. De Nunzio to Senator Harrison Williams, Jr., Dec. 16, 1971.

²⁶ Letter from Senator Harrison A. Williams, Jr., to Ralph De Nunzio, Feb. 8, 1972.

²⁷ Letter from Ralph De Nunzio to Senator Harrison Williams, Jr., Feb. 18, 1972.

The announcement circular when it was distributed in April contained no discussion of the problem of reciprocal arrangements between brokers and life insurance companies. Neither the NYSE nor the SEC appear to have taken any steps to deal with the fiduciary and competitive dangers identified by Senator Williams.

ISSUES AND QUESTIONS

Scope of Self-Regulatory Responsibility

The MSE implemented an extensive program for regulating the sale of life insurance by its members. The NYSE has opposed the development of such a "self-regulatory insurance program," preferring to rely primarily on state insurance regulation. The Commission's view as to the scope of self-regulatory responsibility in this area appears to be closer to the MSE's position than to the NYSE's.

What standards have the MSE, the NYSE and the Commission used in reaching their respective positions on the scope of self-regulatory responsibility for the sale of life insurance?

What is needed in the way of personnel and training for an exchange to operate a full blown self-regulatory program for life insurance sales?

What statutory justification is there for an exchange taking on the regulation of the insurance activities of its members?

In 1961 Mr. Keith Funston remarked: "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."²⁸

Is this still the position of the NYSE?

Do the MSE and the Commission agree with Mr. Funston?

What standards should be used in defining generally the scope of an exchange's responsibility for the non-securities activities of its members?

Should the Commission decide the issue of the proper scope of self-regulatory authority or should the matter be left to individual exchanges? Is there a need for legislative resolution of the issue?

Self-Regulatory Decision Making

NYSE Rule 318 contains no standards to guide determinations of what is a "kindred" activity or what "kindred" activities should be "approved." The case by case decision making which the rule calls for is administered largely through an "oral tradition" with no centralized filing or written compellation of decisions.

In 1971 when the NYSE Board of Governors reversed its 1965 position and decided to permit the sale of life insurance, the NYSE did not explain what changes had taken place to justify the change, and, indeed, did not even address itself to the primary reason for the 1965 position—i.e. assuring high standards of professional service and responsibility.

In neither 1965 nor 1971 did the NYSE obtain a vote of members or request public comments before reaching a decision on the insurance question.

In the absence of written standards, what means does the NYSE employ to insure that its decisions under Rule 318 are consistent and not based on personal considerations and motivations?

What standards were used by the NYSE in reaching its 1965 decision and in reversing that decision in 1971? Were there any significant changes in external conditions during this period?

What steps were taken by the NYSE to assure interested persons an opportunity to have an input into the decision on life insurance?

Although the MSE did solicit comments from its members on the proposal to permit life insurance sales, it did not publicly articulate the basis or purpose of establishing a full-fledged insurance regulatory program. In filing its proposed rules with the Commission, the MSE did not set out the regulatory program that would be established under those rules.

What standards were used by the MSE in reaching its decision to establish a full regulatory program?

Why was no information on this program filed with the Commission?

The Supreme Court pointed out in the *Silver* case that the exchanges have been delegated "governmental power."²⁹ More recently the Fifth Circuit has

²⁸ Testimony at hearings before a subcommittee of the House Committee on Interstate and Foreign Commerce on H.J. Res. 438, 87th Cong., 1st Sess., p. 108 (1961).

²⁹ *Silver v. New York Stock Exchange*, 373 U.S. 341 at 371 (1963); See also Report of Special Study of the Securities Markets, Vol. 4 at 693-698, and 711-713 (1963).

held: "The intimate involvement of the exchanges with the Securities and Exchange Commission bring them within the purview of the Fifth Amendment controls over governmental due process."³⁰

What procedures should the exchanges employ in making significant policy determinations?

Should exchanges be required to give notice and opportunity for public comment before making policy determinations?

Should exchanges be required to give a public statement of the basis and purpose of their policy determinations?

Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure Act) to be followed by the exchanges in making significant policy determinations?

Commission Procedure for Reviewing Exchange Rule Changes

The Commission's review of the NSYE's proposal to permit members to sell life insurance took nearly four and one half months and involved an exchange of eight letters and at least one meeting. Apart from a request for comments from the MSE, this "bargaining" process was conducted entirely in secret with no opportunity for public input into the decision-making process or public scrutiny of the basis for the final decision.

Was anyone other than the MSE interested in the Commission's decision on the NYSE's insurance proposal?

Should there have been notice and opportunity for public comment?

Should there have been a public hearing?

Should the correspondence with the NYSE have been made public?

What are the Commission's procedures for reviewing significant changes in the rules of the various stock exchanges?

Should the Commission develop more "formal" procedures for reviewing exchange rules?³¹

Articulation of Commission Policy

In their letters of December 16, 1971 and February 1, 1972, the staff indicated that the Commission had "no objection" to NYSE member firms selling life insurance, its sole concern being with the "accompanying oversight program which may be required." The Commission has stated that indicating "no objection" is "anything but a 'definitive' determination 'dealing with the merits' of the Exchange's rule amendments."³² However, apart from stating that it had "no objection", the Commission did not express itself on the impact of life insurance sales by member firms on the protection of investors or the public interest; it did not request the NYSE to address itself to these issues or to explain the reasons for the reversal of its previous policy; and it did not express itself on nor did it request the NYSE to address itself to the reasons member firms could now be permitted to sell insurance but were still prohibited from engaging in "non-kindred" activities and "kindred" activities which had not been "approved." The Commission had taken essentially the same "no objection" approach to the MSE's life insurance proposal.

Should there have been public articulation by the Commission of the policy implications of and justifications for removing the restrictions on member firms' ability to sell life insurance?

Should the Commission have made findings regarding the impact on the protection of investors and the public interest of allowing member firms to sell life insurance?

Should the Commission have required the MSE and the NYSE to articulate the reasons for their decision to permit the sale of insurance?

Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal?

Without a written Commission opinion articulating its findings and reasons in passing on exchange rule changes of the importance of the NYSE's insurance proposals, how can the Congress evaluate the adequacy of the Commission's review and oversight procedures?

³⁰ *Intercontinental Industries v. American Stock Exchange*.

³¹ See generally, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 Yale L.J. 811 (1971).

³² SEC, Memorandum in Support of the Respondent's Motion to Dismiss Petition for Review, *Memorial Investor Protective League v. Securities and Exchange Commission* (Nov. 1971).

Commission Handling of Divergent Regulatory Approaches

The MSE and the NYSE took sharply differing views toward their self-regulatory responsibility with respect to members' sales of life insurance. This disagreement is important to the public because of the danger that self-regulatory responsibility may be defined too narrowly. It is also important to exchange members because of the competitive disadvantages at which those subject to more stringent, and expensive, regulatory requirements may be placed.

Why did the Commission decide to leave this disagreement unresolved?

Does the Commission have the authority to establish a uniform pattern for self-regulatory oversight of life insurance sales by member firms?

Is there a need for "equal regulation" of the sale of life insurance by member firms?

Should there have been a hearing directed toward resolving the disagreement between the MSE and the NYSE? If so, what procedural rights should the parties have had?

Could the MSE have obtained judicial review of the Commission's "non-objection" to the NYSE program for insurance regulation?

Is the Commission's failure to bring a uniform regulatory pattern for insurance sales consistent with the Special Study characterization of its role as one of fostering "an orderly and coherent regulatory scheme"?³³

Adequacy of Commission Authority

The staff's letter of February 1, 1972 spells out the Commission's view of the structure of "an adequate self-regulatory program" for the sale of life insurance by member firms. The program the NYSE eventually adopted deviates significantly from the Commission's view.

Why did the Commission fail to require the NYSE to adopt "an adequate self-regulatory program"?

Does the Commission believe it is necessary or appropriate in the public interest or for the protection of investors for the NYSE to adopt an insurance regulatory program embodying the elements explained in the staff's February 1, 1972 letter?

Does the Commission have the authority to review and require changes in stock exchange rules relating to life insurance sales?

Does the Commission lack effective power to require or prohibit changes in exchange rules generally?

Would the Commission's action in handling the NYSE's insurance proposal have been different if it had had the power to require or prohibit the adoption of any rule in accordance with the recommendations in the *Unsafe and Unsound Practices* reports?³⁴

Do the exchanges have authority over the activities of their members which is not subject to Commission oversight? Should the Commission's oversight be coextensive with the rule making power of the exchanges?

Self-Regulatory Initiative

In his November 23, 1971 letter, Senator Williams expressed the concern that permitting NYSE member firms to enter into arrangements for the exclusive marketing of one insurance company's policies might compromise their obligation to recommend to their customers suitable investments, free of external influences or conflicts or interests. In response, the NYSE stated that it would not "interpose itself between member firms and insurance companies" wishing to establish exclusive marketing arrangements for insurance sales. The NYSE justified its position by pointing out that similar arrangements existed for the sale of mutual funds, and that, if such arrangements were "questionable", they would have "been the subject of a ruling by the SEC or other securities regulatory authorities."

Did the NYSE have a responsibility to assure itself that arrangements for the exclusive marketing of a particular company's life insurance policies are consistent with its members' obligations to their customers?

Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on exclusive marketing arrangements the practice is not "questionable"?

Control of Anti-Competitive Practices

Senator Williams wrote to the NYSE on February 8, 1972 pointing out that arrangements for the allocation of brokerage commissions by insurance com-

³³ Report of the Special Study of the Securities Markets, Vol. 4 at 707 (1963).

³⁴ See H.R. 15303, 92d Cong., 2d Sess., Sec. 9 (1972).

panies to brokers selling their policies were "anti-competitive reciprocal relationships," similar to those involving mutual fund sales condemned by the Commission. Despite the fact that the NYSE "expected" such relationships to develop, neither the Exchange nor the SEC have taken action to prohibit them.

Did the SEC investigate the possibility of such arrangements developing and consider their antitrust implications?

Are there reciprocal arrangements now in existence between NYSE members and insurance companies?

Why has the NYSE not taken action to prohibit insurance company-broker reciprocal arrangements?

What responsibility does an exchange have to enforce antitrust policies and to prevent its member firms from engaging in anti-competitive activities or entering into anti-competitive arrangements?

Senator WILLIAMS. The witnesses today come from the SEC, from the New York Stock Exchange and the Midwest Stock Exchange. Gentlemen, would you come forward?

Commissioner Loomis, who was with us yesterday, is from the SEC. From the Midwest Stock Exchange, Mr. Michael E. Tobin, together with Milton H. Cohen, counsel. And from the New York Stock Exchange, Mr. Lee D. Arning, senior vice president, and Donald L. Calvin, vice president, and Robert M. Bishop, vice president of the department of member firms.

You have all had copies of this case study, as I understand it, and you were in on the takeoff as well as the landing; am I correct on that?

Mr. ARNING. That is correct.

Senator WILLIAMS. I understand only Mr. Arning has a statement. Am I right on that? Does anybody else have a prepared statement you want to deliver?

Mr. TOBIN. Yes.

Senator WILLIAMS. I am wrong. Mr. Tobin?

STATEMENT OF A PANEL OF WITNESSES COMPOSED OF PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION; LEE D. ARNING, SENIOR VICE PRESIDENT, NEW YORK STOCK EXCHANGE; DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; ROBERT M. BISHOP, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; MICHAEL E. TOBIN, PRESIDENT, MIDWEST STOCK EXCHANGE; AND MILTON H. COHEN, COUNSEL, MIDWEST STOCK EXCHANGE

Mr. TOBIN. Do you want me first, sir?

Senator WILLIAMS. All right.

Mr. TOBIN. We appreciate this opportunity to appear before the Subcommittee. I am Michael E. Tobin, president of the Midwest Stock Exchange, and with me is Milton H. Cohen, who is a partner in the firm of Schiff, Hardin, Waite, Dorshel & Britton, and also is general counsel to the Exchange.

We believe very strongly in self-regulation. Because we do, we welcome inquiries such as yours into its strengths and weaknesses, successes and failures.

Such inquiries keep self-regulation on its toes, it brings about improvements where needed, and I think it can protect self-regulation from those who would undermine it in the name of less regulation, more governmental intervention, or excessive antitrust emphasis.

Thank you.

Senator WILLIAMS. Thank you very much. Mr. Arning?

Mr. ARNING. Mr. Chairman, in view particularly of the release from the Committee yesterday that indicated you wished to deal with the procedures that were involved, I thought it might be helpful for the Committee for us to review very quickly the procedures that are involved in the decision making process at the New York Stock Exchange.

Let me run through these rather quickly for you so we can set the stage. First of all, I think, as the staff case study points out, the initiating action for any matter presented to the Exchange's Board of Governors begins with the staff of the Stock Exchange.

The proposal may originate from external sources, or internal sources, or the Board itself. The staff then proceeds to develop memorandums, to establish the precedents that have been before the board in prior cases, to weigh the various pros and cons. This is all put in memorandum form that is sent to the Advisory Committee of the Board of Governors.

The Advisory Committee of the board is the committee that meets to deal with issues of rules changes and major policy matters prior to a policy meeting of the board of governors. The policy meeting is held one Thursday a month.

The staff would deliver this memorandum to the governors 10 to 12 days in advance of the policy meeting. The governors would have an opportunity to discuss the memorandum with the staff member who had prepared it and worked on it. The governors could question that party at length, and then that matter would come before the advisory committee at its monthly meeting.

The Advisory Committee is made up of seven members, three members of which are off the floor and three are on the floor, as well as one out-of-town rotating person from other than a New York City firm. However, all governors are free to attend and vote at the Committee's meetings.

This body would deliberate at length as to the matters that were brought before it by the staff. There would be an opportunity for anyone there to make their views known. Members of the Board present have an opportunity to present their views and discuss pending matters with the staff. Traditionally, that meeting of the Advisory Committee has had between 18 and 22 of the then 33 governors of the New York Stock Exchange present at the monthly meetings. You recognize here that we have had a restructuring of the Board in the recent past, and this procedure is no longer the same.

After their deliberations, the Committee would take a vote to accept, reject, or revise the staff proposal. If affirmative action is taken, the Advisory Committee's recommendation is presented to the full board at its policy meeting the next day. After discussion, the full board would either reject, accept, or modify the proposal. If it was a rule change, it would, of course, under SEC Rule 17a-8 be submitted to the SEC.

The action of the board of governors of the stock exchange at this point would be approval in principle for discussion with the SEC.

The matter is then in a position to be discussed with the Securities and Exchange Commission personnel, where, frankly, over the years, we have learned, I think, that they have a viewpoint that can be constructive to the securities industry.

On occasions, particularly very recently, we have distributed publicly, at some breadth, matters that have come before the board. These include such matters as institutional membership, proposed changes in auditing procedures, and the proposals relating to public ownership. All those proposals had wide distribution in the public sphere prior to a final decision by the board of governors.

I would think with the new structure of our board this practice is one that is going to be followed.

In any event, sometimes matters that we sent out for comment get limited comments, whereas when sent out by the SEC, they can generate a substantial amount of public comment. I think the area of public ownership of member organizations is a specific case in point.

In any event, we do have these established procedures. These are the mediums that we have followed. In looking particularly to some of the areas that are involved in this hearing, it seems to me, on reflection, that this matter of life insurance in particular is one where the deliberative processes of the board of governors and the staff extended over a long period of time with an opportunity to develop exceedingly broad interests in areas outside the securities industry.

We also worked with an important committee of the then Association of Stock Exchange Firms which represented the industry at large.

In looking back I would only comment to you, sir, that it seems to be a fair, orderly, and deliberative process that was followed. I thank you, sir.

Senator WILLIAMS. Did this question of diversification to include life insurance ever go to the members broadly, or was it strictly a Board of Governor's decision?

Mr. ARNING. Well, if I could, sir, point out that the Association of Stock Exchange Firms is, in a way, a trade association of the exchange membership. It was their recommendation to the board that brought the matter to the surface. So it had a great deal of exposure in the industry prior to the board action.

Senator WILLIAMS. Let us get a little more fundamental here. There is no doubt about it. This question was an important question. It was permitting the membership to branch out and diversify in an area that had been clearly prohibited.

Am I right on that, both at New York and Midwest?

Mr. TOBIN. Yes sir.

Senator WILLIAMS. This was a departure, and the way in which you arrived at the decision to make this profound change of permitted activity of members is, of course, what we are interested in in our study of how self-regulation works.

As I read the case study, it appeared to me that jurisdictional questions were not clear. Just who could do what?

I think this was true yesterday to some extent, too, as we looked at the question of NASDAQ in the NASD. What are the appropriate areas of jurisdiction at the NASD and at the SEC?

Here, we are talking about a limitation or extension of business activity. Should there be limitations on the type of businesses on which member firms may engage, and, if so, who is, or who should be in the position to set these limitations?

I think that is a broad beginning, but I would like to have your comments on this. As it ended up, the summary of the study left everything

in midair as far as I was concerned. I don't know whether the SEC was saying yes or no, and I don't know whether they thought they had authority to say yes or no.

Could you start, Commissioner Loomis, on that?

Mr. LOOMIS. Surely.

First, I want to indicate by way of background that there is nothing in the Securities Exchange Act of 1934 that prevents a registered broker-dealer from selling insurance, or life insurance, and many have for many years.

Mostly these are smaller NASD firms. The institution of a combined securities firm and insurance agency in smaller cities or towns of the country has been commonplace for years. At least one smaller exchange has permitted its members to do so for sometime. But as has been pointed out in the case study, all of the major exchanges did not permit this until recently.

In light of this provision, we did not believe that we had jurisdiction to say that member firms could not sell insurance when any other registered broker-dealer with the Commission could. I don't want to go into the merits of this thing.

Our attitude, which emerges in the case study, is somewhat passive and noncommittal. It was in part the result of the provisions of the McCarran-Ferguson Act of 1945. Section 2(b) of that act, which seems to be the pertinent part, says that no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, and then goes on, "unless such Act specifically relates to the business of insurance," which the Securities Exchange Act does not.

This statute insofar as the relationship between the Securities Exchange Act and the McCarran-Ferguson Act first came before the Supreme Court in our case of *SEC v. National Securities, Inc.*, decided in 1969, and reported at 393 U.S. 453.

In passing, I would have liked to have argued that case, but the Solicitor General did it instead.

This case involved allegedly fraudulent solicitation of stockholders of an insurance company to approve a merger, or to vote for it. This merger required the approval of the State insurance commission.

Two lower courts held that the commission had no jurisdiction and that even fraud in this transaction was preempted by the McCarran Act.

The Supreme Court reversed, holding that the business of insurance does not extend to transactions in the stock of insurance companies, and as to those the Securities Exchange Act continues to apply in accordance with its terms.

The general thrust of the Court's opinion was that the term the business of insurance does not depend upon who is doing it, whether it is an insurance company or not, but rather upon what is being done.

They went on to say that here it was a securities transaction and not insurance business that was involved.

They did, however, to indicate their position and their analysis, state, citing some prior decisions, that the advertisement and sales of life insurance policies and the licensing of life insurance agents is the business of insurance within the meaning of the McCarran-Ferguson Act.

Presumably it follows from this that, insofar as the Securities Exchange Act of 1934 might be construed as authorizing the commission directly or indirectly through oversight to regulate the sale of insurance by member firms of the New York Stock Exchange under the Securities Exchange Act, this would be contrary to the McCarran-Ferguson Act as interpreted by the Supreme Court.

It is against this general background that this question of the sale of insurance, first by members of the Midwest Stock Exchange and then by members of the New York Stock Exchange, came before the Commission.

The Midwest Stock Exchange was first on the scene, and as will be developed, had a fairly comprehensive regulatory program in the area. They submitted the matter to the Commission, our staff reviewed it, and we reviewed it, and frankly it was our judgment that they had a pretty good program and there was no basis for us to object to it.

The New York Stock Exchange came along later, and while I can't speak for all of my fellow commissioners, I was on the Commission at the time, and I can perhaps state my own reaction, which was that I would have preferred to see the New York Stock Exchange adopt a program more nearly like that of the Midwest.

However, the New York Stock Exchange indicated that they preferred not to do that and expressed their reasons, which were by no means frivolous.

We concluded that, since we had no jurisdiction to require the New York Stock Exchange to put in a program like that of the Midwest, or to prevent their members from selling insurance, all we could do was to remind them of their responsibilities as a public institution and a self-regulatory body.

We did persuade them, if you can put it that way, to provide certain additional reports and data for the purpose of monitoring the activities of their members in the sale of insurance, and we indicated "no objection," which was intended to convey, as the case study points out, that we were not passing upon, endorsing, or approving or disapproving their program, but that from our viewpoint with our jurisdiction we had no objection to their proceeding.

Senator WILLIAMS. This then is an area where you thought other law prevented you from having authority to make a clear determination whether business should be extended; this type of business should be included in permitted activity.

You thought you lacked authority, and that was because——

Mr. LOOMIS. That is correct, sir. The Securities Exchange Act does not mention insurance at all, and as I have said, we can't stop a registered broker-dealer from selling insurance, and many do.

But it could have been said that somehow our general self-regulatory authority over the activity of the exchanges might extend into this area, except for the rather clear command of the McCarran Act as interpreted by the Supreme Court.

Senator WILLIAMS. Let me ask this: Is there a general feeling that there should be limitations on the kinds of businesses that members can engage in?

That must be implied here, that there should be a limitation on the kinds of businesses.

Mr. ARNING. I don't believe so, Mr. Chairman, and let me think out loud with you as to why I say that, and I think you are very familiar

that the concern of the New York Stock Exchange primarily has been member firm capital, the protection of the property of the customers that are on the scene of member organizations, and this, I assure you, we will do with vigor.

Now as to the range of diversification that a member organization may wish to pursue, I don't think there will be any limitations on it. In today's real world where we have negotiated commission rates at declining levels, where we have had a severe impact of the cost-revenue squeeze in the recent past, if our industry has not learned a lesson that it must diversify, then it is in real trouble.

I don't know that you can get in to outlandish areas, and I don't propose that, but there has been an evidence on the part of the public to have a one-stop financial service and to the extent member organizations can contribute to this, I think they should, and I don't think they should be limited in any way as to what might be the narrow area of broker-dealer relationships.

Senator WILLIAMS. That is a personal view on your part, because this suggests to me quite a difference in your view and the guiding rule of the exchange as expressed in Rule 318.

Mr. ARNING. Yes. I indicated that I wanted to think off the top of my head with you to your question as to whether there should be limitations.

Senator WILLIAMS. But under 318 there is a limitation.

Mr. ARNING. Yes, but the one thing I would love to make clear, Mr. Chairman, is the changes which have come about in the securities business in the street, and the competitive stance that the brokerage community is in is a very real one.

This has happened. We are going to have to live through it, we are going to have to change other things.

Senator WILLIAMS. This, of course, is a two-way street. Broker-dealers selling insurance, and insurance companies being members.

Mr. ARNING. It certainly is.

Senator WILLIAMS. It works both ways. We are in a changing and very dynamic period in the lives of financial institutions.

Mr. ARNING. Precisely.

Senator WILLIAMS. But we still are left with Rule 318, which under our broad self-regulation is one of the guides from within the industry. We have a specific area here where the Commission feels it is without oversight authority because of a law that appears to keep them out of a particular decision, but we are still left with who does have the authority, when the business opportunities are being expanded.

For example, and without being specific, hypothesize in your mind a situation where there would be a conflict between the business of being a broker-dealer and another kind of business that he might want to take on. Who would decide, basically, whether that business would be permitted or not?

I can say that on this insurance question you can dream up certain conflicts.

Mr. LOOMIS. Yes.

Senator WILLIAMS. Yet, the SEC is preempted, can't get in, because of the McCarran-Ferguson Act.

Mr. LOOMIS. There are a number of potential conflicts of interest which exist. In fact, there are conflicts of interest in the securities industry as such which have been considered by the Congress over the years, such as the functions of broker and dealer, and so forth.

Now as to your question of diversification, I think I am just speak-

ing off the top of my head, too, and I think I am not too much concerned, aside from the question of solvency and financial impact, about small broker-dealers diversifying into related activities like the real estate business, which they are also in.

We have encountered that and have quite often asked them to incorporate their securities business separately so that their securities customers would not be subjected to liabilities arising out of their other business ventures.

However, I can see a reason why exchanges, particularly the major exchanges, might want to put some controls on the diversification of their members into wholly unrelated areas, and I think there might be situations where the Commission would exercise such powers as it has to control that, or would wish to.

If, for example, an exchange wanted its members to go into the used car business, we might want to have something to say about that.

But the insurance business placed us in a special position because of the presence of the McCarran Act.

Mr. ARNING. Mr. Chairman, I wonder if I might volunteer a little bit of general information. Your staff may already have had this, but along the line of Commissioner Loomis' current comments, he mentioned small broker-dealers. We have not had the walls knocked down at the New York Stock Exchange by member organizations entering the life insurance business.

We have approximately 3,000 registered representatives who have presently been licensed and met the standards of the stock exchange rules that were referred to in your staff study.

Strangely enough, over three-quarters of the firms that are involved with these people are what we define as regional stock exchange organizations, those whose location is outside of New York City and who probably are not defined as nationwide wire houses.

That is something in the vicinity of 5 percent of the total force of registered representatives of the New York Stock Exchange. We have a dozen or a dozen and a half additional firms that are filing data and we assume will be active in it.

We have no way of knowing the scope to which this may expand. It obviously has a major interest to the organizations that have a direct competitive force in the community they are located in.

At the moment, at least, it is not widespread.

Senator WILLIAMS. I wonder if we could now get into your understanding of approaches to a decision of what "kindred" activities should be permitted? I did not get a full appreciation of a formal method of decision here. Rule 318 was the same in 1965 as it was in 1971, is that right?

Mr. ARNING. There were some changes, but I think the point you are making, Mr. Chairman—

Senator WILLIAMS. Did it require at both times approval of the exchange, in order for member organizations to engage in "kindred" activities?

Mr. ARNING. Yes.

Senator WILLIAMS. In 1965, it was decided that selling of life insurance would not be permitted, and 5 years later it was permitted. The discussion here and your opening statement suggested something less than a formal proceeding for the airing of different views prior to a conclusion on the basis of the language of the rule.

It seemed to be informal, a sort of an ad hoc decision rather than any formalized or structural approach to the decision.

Mr. ARNING. Well, Mr. Chairman, I would say it was not ad hoc. It was developed over this period, and we can go back even to late 1958, when we first started to look at it. But in fact, as the material the Committee has had available to it indicates, the Association of Stock Exchange Firms made an extensive study, a survey among themselves, at least the equivalent of an independent consultant's work and perhaps a good deal more, because these people were conversant with the very problems prior to coming before the board, and we had this information in our possession for a substantial period of time.

Now an immense amount of background work was underway, as I am sure you appreciate, throughout the interval. At no time have we had anything other than the greatest cooperation and interest from the insurance companies at large. They have been anxious, I think it is fair to say on their part, that this medium become available.

I have been in touch with these people over the years, and they have been immensely helpful to us in learning the problems of the industry.

I think it was developed over a period of time in a systematic method.

Mr. CALVIN. May I add something to that, Mr. Chairman, and maybe I could offer this memorandum for the record. As Mr. Arning said in his opening remarks, there is an established procedure at the New York Stock Exchange for the promulgation of, revision of, repeal of, and development of rules, as well as related policy changes.

Simply stated, without repeating the whole procedure again, it revolves around a memorandum which is prepared by the Exchange staff. This memorandum is distributed to the Board of the Exchange well in advance of their discussions. The key document in those discussions in this memorandum. In the case of this issue which we are discussing, the document which I have in my hand is the memorandum of November 9, 1971, captioned "Sale of Life Insurance by Member Organizations" which was sent to the board.

It is thicker, for example, than the case study prepared by your staff. The November 9 memorandum takes into account the precedents, the relevant precedents, in this area in the past. It discusses developments in this area. It includes documentation by way of the studies made by the Association of Stock Exchange firms, to which Mr. Arning referred, and includes the text of draft rules. It is, in other words, a detailed professional expose of this topic which concludes with a recommendation from the staff to the advisory committee of the exchange.

The Members of the Advisory Committee then have an open and frank discussion of this memorandum and the staff recommendations. They then make their own independent recommendation to the board.

So I think it is clear, and if this document is included in the record I think the record will be clear, that there is an established procedure for handling these matters. Rules changes are made in a formalized way. Before acting, precedents in the area which is the subject of the recommendation are reviewed and taken into account.

To that extent, I would submit that it is really not an ad hoc decision-making process. I would offer this memorandum for the record, if you have no objection.

(The memorandum referred to follows:)

NEW YORK STOCK EXCHANGE, INC.

M E M O R A N D U M

March 16, 1972

TO: Board of Governors
FROM: Advisory Committee
SUBJECT: SALE OF LIFE INSURANCE BY MEMBER ORGANIZATIONS

The Advisory Committee considered the staff memorandum dated March 7, 1972 and recommends to the Board of Governors final approval of amendments to Rules 345.17(I), 311 and 351 as shown in the memorandum dated November 16 and the amendment to Rule 318.13 shown in the memorandum dated February 17 to permit member organizations to engage in the sale of life insurance.

NEW YORK STOCK EXCHANGE, INC.

Department of Member Firms

M E M O R A N D U M

March 7, 1972

TO: Advisory Committee
FROM: Lee D. Arning
SUBJECT: SALE OF LIFE INSURANCE BY MEMBER ORGANIZATIONS

Attached are memoranda relating to the sale of life insurance by member organizations. This subject will be discussed at the March Policy Advisory Meeting.

Att.

NEW YORK STOCK EXCHANGE, INC.

MEMORANDUM

February 17, 1972

TO: Board of Governors

FROM: Lee D. Arning

SUBJECT: New Rule 318.13

The attached proposed new rule 318.13 has been drafted to meet the Concerns of the Staff of the SEC, as expressed in Mr. Rappaport's letter to me of February 1, 1972, which is attached to this material. Preliminary discussions yesterday with Mr. Rappaport indicate that the rule draft appears generally satisfactory to him, but must, of course, be cleared with the Commission.

The rule strives to establish levels of oversight and surveillance in meeting the concerns of the Commission, but not superimposing standards of the Exchange (which possesses virtually no expertise) on an industry highly regulated by the various State Commissions.

The Advisory Committee recommends Board approval in principle, for further review of the rule with the SEC and to be returned for final action and implementation by the Board.

Lee D. Arning

RULE 318.13

A member organization may engage in the sale of life insurance (directly, or through its corporate affiliate or subsidiary) only through one or more members, allied members and registered representatives of such member organization each of whom is then in compliance with the licensing and any other requirements of applicable insurance laws and regulations.

Each member organization which engages in the sale of life insurance shall promptly report to the Exchange the name of each person through whom such member organization sells life insurance, the training in the sale of life insurance received by each such person, the state or states in which each such person is licensed to sell life insurance and the names of the life insurance companies for which each such person is licensed in each such state.

Each member organization which engages in the sale of life insurance shall also keep current in a separate file within the member organization the following information:

(1) a description of the member organization's supervisory program as related to the sale of life insurance; the name of each member, allied member or employee within the member organization who has been given the responsibility of exercising supervisory control over the persons engaged in the sale of life insurance and the specific responsibilities of each such person.

(2) a description of the member organization's surveillance program as related to the sale of life insurance, the name of each member, allied member or employee within the member organization who has been given the responsibility of exercising surveillance responsibilities and the specific responsibilities of each such person.

(3) sales and other records relating to the member organization's sale of life insurance as deemed appropriate by the member organization including, without limitation, records disclosing the types and amounts of life insurance sold, the commissions earned and the commissions paid to individuals engaged in the sale of life insurance. Such records shall be maintained in a reasonably accessible location for inspection by the Exchange for not less than three years.

NEW YORK STOCK EXCHANGE, INC.

M E M O R A N D U M

February 8, 1972

TO: Advisory Committee
FROM: Lee D. Arning
SUBJECT: SALE OF LIFE INSURANCE

Question for Discussion

Should the Exchange establish a program for regulation of the sale of life insurance by member organizations?

Background

On November 18, 1971, the Board of Governors approved in principle rules providing for the sale of life insurance by members and member organizations. The Exchange, in effect, removed the prohibition against the sale of insurance; required any such sales to be by a person either member, allied member or registered representative; but, in recognition of the extensive state regulation, did not involve itself in regulation aspects of the sale of life insurance.

The proposed rules were dispatched, in the regular course, to the SEC. Prior to the December policy meeting - in response to our query - the staff of the Commission asked that the Exchange Board of Governors not proceed until further study had been made, and in particular wanted us to review the insurance program of the Midwest

Stock Exchange. The Exchange found little to support the Midwest concept and so responded, seeking Commission review so that the matter could be presented to the January policy meeting.

The Commission staff on January 16, 1972 indicated that review could not be completed by the policy meeting date and asked that final action not be taken at that time. As the Committee is aware, the request was complied with. Further pressure on the Commission staff resulted in a communication, dated January 27, to Richard B. Howland, asking that the Exchange take no action until Commission comments could be obtained. On February 1, the Commission advised that while it did not object to the sale of life insurance by member organizations in principle, it did believe that an adequate self-regulatory program should be developed before the Exchange permitted such sales (see letter attached).

Discussion

It is known that a number of member organizations have advanced their own programs to qualify registered representatives, to develop insurance expertise and to hire insurance experts, and that a number of insurance companies have advanced programs to train, guide and assist in life insurance sales based upon the earlier Board of Governors approval in principle.

An extensive self-regulatory program appears to be the Commission's direction - modeled in part at least on the views of the Midwest Stock Exchange. Since the New York Stock Exchange has no expertise in this area, assistance and personnel would have to be acquired. This aspect was recognized in the initial Board of Governors review, and the decision was made at that time that this route was not desirable.

Question for Discussion

In view of the SEC response to the proposed rule changes - should the Exchange develop a self-regulatory life insurance program?



OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

February 1, 1972

Mr. Lee D. Arning
Senior Vice President
New York Stock Exchange, Inc.
4 New York Plaza
New York, New York 10004

Dear Mr. Arning:

The Commission has reviewed the Exchange's proposed rules which would permit member organizations and their salesmen to sell life insurance and correspondence with the Exchange on this subject, including your latest letter of January 7, 1972.

We are aware that Exchange members engage in other non-securities business activities. However, in view of the Exchange's representation respecting its pre-eminence in the training of member organizations' registered personnel, it would be unfortunate if some member organizations fail to proceed in their insurance sales activities with the care expected by the public. This could impair the confidence of investors in the securities and other activities of both those members and the Exchange itself.

Accordingly, while, as we have previously indicated, the Commission does not object in principle to the sale of life insurance by member organizations, the Commission does believe that an adequate self-regulatory program should be presented before the Exchange permits its members to proceed with this new activity. The Commission has in mind Exchange-established training standards insuring a uniform minimum level of expertise, rules requiring adequate recordkeeping to facilitate Exchange surveillance, and uniform standards designed to help assure financial responsibility of insurance companies whose policies your members will sell.

Our staff is available to assist in the development of the program.

Sincerely,


Sheldon Rappaport
Associate Director

NEW YORK STOCK EXCHANGE, INC.

Department of Member Firms

M E M O R A N D U M

November 9, 1971

TO: Advisory Committee
FROM: Department of Member Firms
SUBJECT: Sale of Life Insurance by Member Organizations

QUESTION

Should the Exchange permit the sale of life insurance
by member organizations?

POLICY

Under Rule 318, with the prior approval of the Exchange, member organizations may engage in activities kindred to the securities business. Starting in 1958 the Exchange has turned down all requests from member organizations to engage broadly in the sale of life insurance. However, a few narrowly defined exceptions have been made. Registered representatives may hold insurance licenses where required by state law to offer mutual fund contractual plans carrying a completion term life insurance feature, to offer mutual fund redemption value insurance, to offer group term life insurance on debit balances in margin accounts and to receive renewal commissions resulting from life insurance sales made prior to their becoming registered representatives.

BACKGROUND

Following the 1969-70 depression in the securities business, a number of member organizations have asked the Exchange to reconsider

its position on the sale of life insurance. In a letter dated January 7, 1971 the Association of Stock Exchange Firms urged the Exchange to take early action to permit its member organizations to sell life insurance subject to appropriate safeguards. This letter was accompanied by a report on the results of an ASEF survey on life insurance sales and a memorandum submitted to the ASEF Board of Governors by its Committee on Life Insurance Sales. The letter, the report and the Committee memorandum are all attached as Exhibit I.

Briefly, the ASEF survey showed that of 202 firms responding, 55% favored the Exchange broadening this rule to permit the sale of life insurance, 27% were against and 18% had no opinion. Excluding 16 Floor oriented firms having no direct interest in the sale of life insurance, 59% were in favor. Most major retail firms were included among those in favor.

In another survey conducted by the Exchange concerning the future of the small investor, 26 regional firms were asked whether they thought the Exchange should permit member organizations to sell life insurance and 22 of them replied yes. In this survey 8 out of 10 major retail firms who were asked the same question also said yes. In addition, the Marketing Advisory Committee of the Exchange, composed of key marketing executives of member organizations, made a study several months ago and included in its recommendations that the Exchange should permit the sale of life insurance.

THE MIDWEST STOCK EXCHANGE PROGRAM

The Midwest Stock Exchange changed its rules a little over a year ago to permit its member firms to sell life insurance. The MSE reports that during the first year, which ended June 30, 250 securities salesmen in 25 MSE member firms sold \$255 million face value in life insurance and generated \$3.4 million in commissions. In doing this they report they dealt with some 80 insurance carriers.

The Midwest states that it takes an active role in the life insurance field. All plans to sell insurance must be filed with and approved by the MSE, and subsequent periodic reports must be made describing the type and amount of insurance sold and the carriers by whom it was written.

All life insurance salesmen must pass an MSE insurance examination, unless they have had at least two years experience in life insurance sales. This examination is claimed to be more difficult than qualifying examinations of most of the states. The MSE also has a training course which it sells to its member firms to train their life insurance salesman. The course is mandatory.

In addition to requiring the above, the MSE counsels its members on such questions as what kind of life insurance programs they should offer, what carriers can provide these programs and how best to negotiate with the carriers. Officials of the MSE have expressed their willingness to assist the NYSE in setting up a similar program.

DISCUSSION

The arguments presented by the ASEF in favor of permitting the sale of life insurance are contained in Exhibit I. Briefly, they are that customer demand is increasing for a full range of financial services, that member organizations need to diversify their sources of income in the face of rising costs and the cyclical nature of the securities business, and that competition for savings dollars and competent salesmen is becoming more acute.

In addition, it should be noted that other financial organizations have diversified their activities in recent years. Banks, with certain restrictions, sell life insurance and act as agents for the purchase of securities; insurance companies are entering the securities business through mutual fund sales, through membership on regional exchanges and through purchases of brokerage firms. Travelers, John Hancock, Connecticut General, Mutual of Omaha, Fidelity Mutual and Allstate are all engaged in the sale of mutual funds, and since 1969 five major insurance companies have been admitted to membership on the Philadelphia Exchange.

Against the proposal it can be argued that participation in the sale of life insurance by member organizations might increase the pressure from life insurance companies to become members of the Exchange, just as the participation of member organizations in the operation of mutual funds has increased the pressure from mutual funds and their affiliates to become Exchange members.

On the other hand, it can be said that the sale of life insurance is no more a participation in the life insurance business than the sale of mutual fund shares is a participation in the mutual fund business. Under this view, the equivalent of managing a mutual fund would be the actual writing of life insurance, which is not contemplated in the ASEF request.

If the Exchange were to determine that its member organizations should be permitted to sell life insurance, the Board of Governors would have to decide the depth of participation to permit and whether the Exchange should provide a regulatory and counseling structure similar to that of the Midwest Stock Exchange.

REGULATORY CONSIDERATIONS

The staff has held discussions with the New York State Department of Insurance to gain an overview of life insurance problems. As a condition of registration, insurance companies registered to do business in New York must observe New York insurance laws and regulations wherever they do business.

New York State has long been acknowledged to be a leader in insurance regulation. However, there has been a general improvement in the quality of state insurance regulation in recent years, and a number of states are today considered to be on a par with New York in this respect.

In general, the regulatory burden under state laws is imposed on the insurance underwriter rather than the salesman. It is true that individual brokers and agents are subject to a licensing requirement and must pass a qualifying examination. However, no blanket licenses are issued. Instead, separate licenses must be sought for each insurance company to be represented, and except under very infrequent and carefully defined circumstances agents and brokers may not place insurance with any company for which they are not licensed. In no event may they receive compensation from any company for which they are not licensed.

The New York State Department of Insurance receives approximately 20,000 complaints a year. Of these, about 5% relate to life and health insurance, despite the fact that life insurance premiums account for more than half the premium income of companies registered to do an insurance business in New York. Almost all of these complaints arise from mechanical errors in billing, addressing, etc. or involve health insurance, and do not involve life insurance salesmen as such.

The New York State Department of Insurance can fine or revoke the license of a life insurance salesman for violation of insurance laws or regulations. Department officials state that disciplinary actions against life insurance salesmen in recent years have been rare, except in the case of persons registered to sell both life and property insurance who have been disciplined for actions involving property insurance.

The New York State Department of Insurance has indicated that it will follow up any complaints or allegations of violation of insurance laws or regulations which are referred to it by the Exchange.

The NASD has for some years admitted to its membership organizations which were primarily engaged in the life insurance business. As a result, about 25% of the NASD's 200,000 registered representatives are persons who are primarily life insurance salesmen. This characteristic of having the securities activity a sideline for people basically engaged in the sale of insurance has given the NASD some regulatory concern. Consequently, the NASD has included in its Board of Governors two persons who are primarily in the insurance business. Also, insurance industry representatives are on about one-half of the business conduct committees and it is expected that there will be insurance industry representation on all of them before long. The NASD reports that incidents of misconduct involving the sale of life insurance by their registered representatives have been very rare, and that all of these involve persons whose primary activity is the sale of life insurance.

The NASD also has some concern about "suitability" of recommendations to customers involving both insurance and securities. Most of this concern involves the question of how far the NASD should pursue the question of supervision and control in those of its members which are essentially insurance companies. They

do not feel the same concern in those of its members which are essentially securities firms because of their basic familiarity with the securities business.

In summary, most of the concern of the NASD arises from the fact that its membership contains insurance companies who want to be able to sell a securities product essentially as a sideline. The Exchange's primary purpose rule presently prevents organizations of that sort from becoming members of the Exchange, and also prevents existing members from evolving into insurance companies.

The Exchange, of course, has a duty to enforce insofar as practical its Constitution and Rules. One of the basic objectives of the Exchange Constitution and Rules, and of the Securities Exchange Act of 1934 as well, is to maintain high standards of commercial honor and integrity among members and to promote just and equitable principles of trade and business. Many of the Exchange rules are aimed at meeting these objectives. It would seem that fraudulent or other improper activity on the part of member organizations would be in violation of these concepts even though the improper activity concerned the sale of insurance rather than securities. Failure of the Exchange to enforce its rules where it knew or should have known of the improper activity could give rise to legal liability on the part of the Exchange. However, this situation already exists with

respect to member organization activities in other non-securities area; for example, commodities and real estate syndication activity. Experience in these non-securities areas has not shown any serious exposure. The staff's inquiries into the sale of life insurance does not indicate that this activity should be expected to give rise to significant potential exposure to the Exchange.

METHODS OF EXCHANGE CONTROL

There are at least three possible ways in which the Exchange could permit life insurance sales by its member organizations, as follows:

First would be the approach taken by the Midwest Stock Exchange described above. The advantages of this would be a broad control over the life insurance activities of member organizations and an opportunity to add to Exchange revenues through a charge on insurance commissions.

On the other hand, the Exchange staff is not today equipped to regulate insurance activity. Further, there is a question as to whether the Exchange should attempt to regulate a non-securities activity which is already subject to extensive regulation by state authorities. In addition, it is doubtful that Exchange member organizations want or need the kind of counseling offered by the MSE to its members. On balance, it appears that a pervasive role in life insurance sales by member organizations along the lines of the MSE program would not be appropriate for the Exchange.

A second approach would be the contrary of the one described above - to permit member organizations to engage in the sale of life insurance without qualification or limitation of any kind. This would require no additional work or expense on the Exchange's part and might be acceptable if the Exchange had extensive experience with the sale of life insurance by member organizations. However, it does not appear to be an appropriate initial posture in the absence of any experience.

A third approach would be to avoid the two extremes above and provide a standard which would be required of member organization personnel who engage in the sale of life insurance without incurring the expense and expending the effort necessary to provide the regulatory and counseling structure provided by the MSE. This could be done by withdrawing the traditional objection to the sale of life insurance by member organizations provided that life insurance is sold only by persons qualified to sell securities, and that those persons are properly licensed under applicable insurance laws.

The requirement that individuals who sell life insurance for member organizations must also be qualified as registered representatives to sell securities would have several benefits. It would extend to those who sell life insurance the investigative and other qualification requirements required for Exchange approval of registered representatives. In addition to original qualification

requirements, registered representatives who sell life insurance would continue to be subject to all the other rules governing the conduct of registered representatives, including the requirement that they be full time employees of their member organizations.

More important, limiting insurance sales to registered representatives would assure that any individual selling life insurance would have at least a minimal knowledge and appreciation of the securities business and its products. This would be consistent with the requirement that member organizations have the securities business as their primary purpose.

Most member organizations interested in the sale of life insurance plan to have it offered by their present registered representatives, so this requirement would fit in with their plans. Those who sought to employ experienced insurance salesmen would find many of them already have qualified as NASD registered representatives, so that they could take the Exchange qualifying examination as soon as they had prepared themselves for it rather than undergo a full six month training period.

One of the basic concepts in the Exchange rules governing the activities of registered representatives is that they may be compensated only by their member organization employer for work which they perform and for which their member organization employer is paid. This is consistent with the Exchange's requirement that member organizations assume responsibility for supervision and control of the registered representatives in their employ. It would be appropriate to extend this principle to commissions generated through the sale of life insurance.

The practice of the life insurance business is that in many cases commissions are paid directly to the individual rather than to his employer. Further, the laws of at least two states do not permit insurance commissions to be paid to a corporate broker. However, insurance companies believe that this could be overcome by having an individual in the member corporation designated to receive commissions which he would then turn over to the member corporation.

In the event a registered representative were to change member organization employers, the assignment of trailer commissions could be changed to the new employer organization with the approval of the policy holder. This would be comparable to the reassignment of dealer commissions on mutual fund accumulation plans.

The limitation to life insurance would permit the Exchange and its member organizations to gain experience in one facet of the insurance business before considering whether to expand the permission into other types of insurance. This step-by-step approach would make for an orderly and controlled entry into the insurance business.

The Exchange would refer complaints that might be received relating to insurance matters to the individual state insurance commissions for their attention in the same way AMEX and NASD complaints and conduct matters are referred to those agencies if the securities involved are under their jurisdiction.

Financial reports on life insurance sales could be included in the reports now required by the Exchange by adding the appropriate questions to presently used forms.

If the Exchange determines to permit its member organizations to sell life insurance, the third method of control would appear to be the most desirable. It could be put into effect by amending Rule 345.17 and adopting a new Rule 318.13 as shown in the attached Exhibit II. A realistic target date for implementation of the amended rules would be January 1, 1972, assuming final approval by the Board at its December Policy Meeting.

RECOMMENDATION

That the Advisory Committee recommend to the Board of Governors that it approve in principle - for discussion with the SEC staff and resubmission at a future meeting of the Board - amendment of Rule 345.17 and adoption of a new Rule 318.13 to permit the sale of life insurance by persons qualified to sell securities.

ASSOCIATION OF STOCK EXCHANGE FIRMS
120 BROADWAY
NEW YORK, N. Y. 10005

OFFICE OF THE CHAIRMAN

January 7, 1971

(212) 427-6722

Mr. Robert W. Haack, President
New York Stock Exchange
11 Wall Street
New York, New York 10005

Dear Bob:

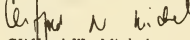
As you know, the ASEF's Committee on Life Insurance Sales by Member Firms, under the chairmanship of Andrew F. Peck, has been studying the question of whether it would be advantageous to member firms to be permitted by the Exchange to engage in the business of selling life insurance in addition to their present product lines should they wish to do so. Several months ago, the Committee determined through a survey of the membership that a strong interest exists on the part of many firms through the country to have such permission. The results of this survey confirmed the Committee's own conviction that insurance sales by member firms would not only provide firms with an important new source of commission revenue but would also offer the advantages of product diversification in a highly cyclical industry. Important corollary benefits, the Committee felt, could also be expected through the creation of opportunities for expanded customer service -- to corporate clients in such areas as employee group insurance and pension planning and to individuals looking to their member firm investment advisors for more rounded financial facilities.

In view of the strong membership interest in this subject, our Board now formally urges the Board of Governors of the NYSE to take early action to permit the sale of life insurance by member firms, subject to appropriate safeguards. Our advocacy of sale of insurance as sales brokers and agents should not be confused with ownership of insurance companies.

Accordingly, on behalf of the Board, I am enclosing a copy of the Resolution adopted January 6, 1971. I am also pleased to enclose memoranda reflecting the results of our membership poll conducted six months ago and the work done by the ASEF staff in support of the Peck Committee's efforts. These may be helpful to your staff in its continuing study of the matter.

We urge the earliest possible consideration of this subject by the Board of Governors of the Exchange.

Sincerely,


Clifford W. Michel
Chairman

CWM:cb
Enc.

Resolution Adopted by the Board of Governors of the
Association of Stock Exchange Firms, January 6, 1971
Regarding the Permissive Sale of Life Insurance by
Member Organizations of the New York Stock Exchange

RESOLVED THAT:

WHEREAS: customer demand is increasing for fuller and competent in-depth financial servicing in areas other than those presently available through a broker-dealer in securities or commodities; and

WHEREAS: member firms are desirous of diversifying their activities and broadening their sources of revenue so as to remain viable in the face of steadily rising operating costs and erratic movements in securities trading volume; and

WHEREAS: nonmember competition for the public's savings dollar and for competent sales personnel is becoming more acute;

THEREFORE: Be it resolved that the Association of Stock Exchange Firms requests the New York Stock Exchange to act promptly to permit its member organizations to engage in the business of selling life insurance, subject to such controls as the Exchange may find necessary or appropriate to assure adherence by members to standards in the insurance area comparable to those observed in the conduct of the securities business.

RESULTS OF ASEF SURVEY OFMEMBER FIRMS ON THE SUBJECT OF LIFE INSURANCE SALES.

August 11, 1970

MEMORANDUM

To: Mr. Harold A. Rousselot

From: James H. Ording

Subject: Life Insurance Sales by NYSE Members

On July 22nd, a questionnaire was addressed to managing executives of ASEF member organizations asking for their views on the subject of permitting NYSE member firms to offer life insurance to customers. They were also asked to indicate the degree of interest, if any, their firm might have in getting into the life insurance business.

As of August 11th, 202 firms had responded. Of this number, all but 16 firms serve the investment needs of public customers. The remaining respondents represent specialist units or other Floor-oriented firms having no direct interest in the matter beyond the question of the principle involved and its possible bearing on the issue of admitting insurance companies and other institutions to Exchange membership.

The responses of the 202 firms answering the questionnaire are summarized as follows:

As a matter of principle, do you feel the NYSE should broaden its rules to permit interested member organizations to offer life insurance to customers in addition to securities?

	Number	% of Total
In favor	112	55%
Against	55	27%
No opinion	35	18%
	<u>202</u>	<u>100%</u>

Assuming the Exchange amended its rules to permit such activity, which of the following statements would most nearly describe your firm's probable reaction?

	Number	% of Total
No interest in selling insurance.	85	42%
Sufficiently interested to look into the pros and cons of the matter, with a possible view toward adding life insurance to our present product line.	92	46%
Strongly interested and would act as promptly as possible to offer insurance to customers.	25	12%
	<u>202</u>	<u>100%</u>

Eliminating from the group of responding firms the 16 not sales oriented, we find the percentage figures to be closely related to those for the entire group. Here, 59% of the firms declared themselves in favor of the principle involved (as compared with 55% for the entire group) and 63% of the firms are interested in entering the insurance business or looking into the pros and cons of doing so (as compared with 58% on an overall basis.)

While sentiment generally appears to favor broadening the NYSE rules to permit entry into the life insurance business, leading firms are found on both sides of the issue. Of 17 responding firms of some magnitude in the industry, 10 expressed themselves as being in favor of such a step while 7 are opposed. A list of these firms is attached (Appendix A.) It will be noted that a number of the larger, more prestigious firms, are missing from the list by reason of not having responded to the questionnaire.

It may also be of interest that 15 firms presently represented on the Board answered the questionnaire. Of this number, 2 had no opinion on the issue. The remaining 13 showed 8 in favor and 5 against.

A number of firms commented briefly on the subject. A representative sampling of these comments is attached as Appendix B.

Observations

Substantial sentiment appears to exist to have the question of life insurance sales reopened by the NYSE. Only about one-quarter of the responding firms take a negative view, with the remaining three-quarters either favoring a lifting of the barrier by the Exchange or taking a neutral position.

Some 14% of those firms which service the public investor are strongly interested in entering the insurance field while another 49% would investigate the pros and cons of the matter before coming to a decision. It is worth noting, however, that a number of firms stated that the force of competition within our own industry would probably compel them to sell insurance should that be permitted, although they are not enthusiastic about the prospect of being placed in this position.

To the extent that firms taking a negative stance on the issue offered reasons for doing so, they appear to share the view that "if we get into the insurance business how can we hope to keep insurance companies out of ours." Other firms, however, taking a positive approach, say "insurance companies are in our business now, selling mutual funds, variable annuities and other equities. We must have freedom to compete in order to survive."

Conclusion

The survey indicates sufficient membership interest in the subject to merit our pursuing it through the Life Insurance Sales Committee, with a view to bringing the Committee's recommendations to the Board at the New Orleans meeting.

JHO:cb
Attach. (2)

August 14, 1970

APPENDIX ALeading Firms in Favor

Bache & Co. Incorporated
A. G. Becker & Co., Inc.
Clark, Dodge & Co., Inc.
F. I. du Pont, Glore Forgan & Co.
Eastman Dillon, Union Securities & Co.
A. G. Edwards & Sons, Inc.
Hayden, Stone Incorporated
Hentz & Co.
E. F. Hutton & Co., Inc.
Merrill Lynch, Pierce, Fenner & Smith, Inc.
Shearson, Hammill & Co., Inc.
Thomson & McKinnon, Auchincloss
Dean Witter & Co., Inc.

Leading Firms Opposed

Bear, Stearns & Co.
Burnham & Company
Dominick & Dominick, Inc.
W. E. Hutton & Co.
Kidder, Peabody & Co. Inc.
Lehman Brothers
Loeb, Rhoades & Co.
Shields & Co.

APPENDIX BRepresentative Comments by Firms

"To maintain our share of investment dollars, we must have ability to compete with insurance companies."

"We feel strongly against dual licensing. We would not fight any change in Exchange rules to permit. However, in all probability, we would not avail ourselves of the opportunity if available."

"We have asked the NYSE several times over the past 4 or 5 years to allow us to sell insurance. We have been turned down each time."

"Without a doubt many firms will not be interested. However, once the ice is broken, many will see the light. Let's break the ice."

"This would be a very important addition and would fit in very well with the 'total asset management' concept."

"It's about time we are beginning to explore opportunities of this nature to enhance the income of member firms. Let's hope this is the initiation of new 'creativity' by the Association."

"Strongly against - would put smaller firms of our type at even more of a competitive disadvantage against the large firms."

"We must offer complete financial planning services or will lose a share of our rightful business to insurance companies."

"We should definitely have this additional merchandise as it goes well with mutual fund as a package - Also supplements badly needed income."

"We deem it of critical importance to broaden our sources of revenue in order to remain viable in the face of steadily rising costs, limited prospects for increased commission rates and erratic movements in securities trading volume. The sale of insurance and the commission generated thereby would tend to stabilize revenues through swings in market cycles."

"We are very much against the sale of insurance by member firms."

APPENDIX B (cont'd)Representative Comments by Firms

"Believe that this is a logical extension of a complete package for investment counseling."

"We believe firms should have the opportunity to participate in this business, particularly with specialized personnel involved."

"It is vitally necessary that member firms get into the race for providing complete financial service as soon as possible. Even if we start immediately we would be some years behind our competitors. The investment public needs competent in-depth financial service, and the member firms are the most likely to do it with the highest degree of efficiency if they would be allowed to profit. It would also provide a stabilizing income for planning and budgeting by us all."

Memorandum Submitted to the ASEF's Board of Governors by the
Committee on Life Insurance Sales in Support of a Proposal for
Removal by the New York Stock Exchange of its Restrictions
Against Life Insurance Sales by Member Organizations.

ASEF Committee on Life Insurance Sales
by Member Firms

Andrew F. Peck, Chairman

Clark, Dodge & Co. Incorporated

Chapman Clarke

Thomson & McKinnon Auchincloss Incorporated

John C. Jansing

Bache & Co. Incorporated

John A. Orb

Merrill Lynch, Pierce, Fenner & Smith, Inc.

Bertram M. Wilde

Janney, Battles & E. W. Clark, Inc.

October, 1970

SALE OF LIFE INSURANCE BY
NYSE MEMBER ORGANIZATIONS

The question of whether member organizations of the New York Stock Exchange should be permitted to engage in the sale of life insurance has been raised many times with the Exchange's Board, and each time the Board has said no. The provisions of Rule 318 have been cited as the basis for this policy. This rule restricts member organizations to engaging primarily in the business of broker or dealer in securities or commodities. With Exchange approval, members may engage in "kindred activities" but the Board does not regard the sale of insurance as being "kindred" to that of the securities business.

There is ample evidence that many member firms do not share this view. Changing conditions in the economy and in the securities business itself are compelling firms to take a fresh look at the feasibility of expanding their businesses through the introduction of new product lines and customer services. The public penchant for "one stop" shopping, mounting competition from insurance companies and nonmember broker-dealers, and the vital need for new sources of income and diversification of business, all appear to be contributing toward a renewal of interest in having the matter raised again at the NYSE Board of Governors level.

ASEF Involvement With the Issue

In early 1968, the ASEF's Executive Committee determined to look into the question of whether member firms and their registered representatives should be permitted by the Exchange to sell life insurance and variable annuities in addition to securities. A committee was appointed under the chairmanship of Bertram M. Wilde. This committee examined into various aspects of the matter and concluded that conceptually the idea of affording member firms greater latitude in engaging in such activities as the sale of life insurance was basically sound. It was agreed that should the NYSE remove the barrier to such activity, it would serve to open up appropriate new avenues of needed revenue for member firms and enable them to round out the financial services available to customers. The Committee also found, however, that as a practical matter the industry was faced with too many uncertainties at the time to risk compounding its problems by permitting members to engage in new fields of endeavor while they were experiencing severe difficulties in handling expeditiously the securities business they already had. The Committee, therefore, recommended that the Exchange be advised that the ASEF was sympathetic to the views of members seeking relief from the onerous restrictions placed upon members in this regard and felt the question should be reopened for active consideration as soon as the industry's operational capacity had improved to the point of being able to take such a development in stride. The Board concurred with the Committee's findings and advised the Exchange accordingly.

By late 1969, the situation had changed dramatically in the industry. Market trading volume was at a relatively low level; firms were having difficulty in operating profitably with the limited product line permitted; customer demand for complete and comprehensive financial counseling was said to be increasing; principals and registered representatives were seeking new sources of personal income; and the operations "logjam" which plagued the industry in 1968 and early 1969 had been broken. The Board responded by appointing a new Committee to review the various facets of the problem in the light of the changed conditions to ascertain whether the time had come to revive the matter with the NYSE.

This Committee, under the chairmanship of Andrew F. Peck, reported its findings to the Board of Governors in May in St. Louis. It reaffirmed the views of the earlier Committee and suggested that the Exchange be prevailed upon once again to consider amending its rules to permit interested member organizations to engage in the business of selling life insurance. The Committee agreed that such activity should be subject to such control as the Exchange might find necessary or appropriate to assure adherence by members to standards in the sale of life insurance comparable to those observed in the conduct of the securities business.

In arriving at this conclusion, the Committee took cognizance of action taken by the Midwest Stock Exchange to allow members to sell insurance as an ancillary financial service to public customers. It also anticipated that the NYSE, if approached again at this time, might find such policy questions as that of nonmember access and institutional membership to have such a close relationship to the question of life insurance sales as to make it inappropriate to reconsider the insurance sales question until the more fundamental issues are resolved. The Committee felt, however, that these matters were not so interrelated that they could not be dealt with effectively as separate matters.

The Board was sympathetic to the Committee's views and directed that the matter be pursued diligently in whatever way the Committee might think appropriate.

The Factor of Competition

Competition with insurance companies, nonmember brokers and dealers and other financial institutions takes two principal forms - competition for the investors' savings or speculative dollar and competition for able, energetic and productive salesmen. Insurance companies, in search of profit opportunities in the area of equity investment, are becoming more and more active in offering variable annuities and mutual funds, and nonmember broker-dealers, free of NYSE restrictions, are combining equities and insurance in offering customers the advantages of "one stop" financial shopping through multiple product merchandising. NYSE members, therefore, are becoming increasingly concerned that unless they are free to meet this challenge they will find themselves at a distinct competitive disadvantage in endeavoring to fulfill the investment needs of customers.

Competition for salesmen may concern a larger segment of the industry than that for business per se. Some firms seem justifiably concerned that the young potential salesman seeking a rewarding career in finance may well shun the member firm community when faced with a choice of working for a financial organization where he can sell insurance, variable annuities, mutual funds and other securities, or for a member firm where his opportunity and sales vision may be limited. This may become even more of a problem should salesmen's incomes decrease due to less generous commission-sharing arrangements or to prolonged periods of low volume in the securities markets. Increasing income potential by broadening the line of financial products and services available for sale seems a logical approach to problems brought on by the profits squeeze in the industry and perhaps essential to the recruiting and maintenance of a capable and contented sales force.

Evidence of the eagerness of nonmember firms and insurance companies to attract productive salesmen away from member firms may be found daily in the classified ads appearing in such publications as the Wall Street Journal. One such recent ad offers "the opportunity to sell a balanced combination of mutual funds and life insurance via our exclusive proved-effective, computerized Financial Planning Program. (If you don't have a life insurance license, we'll help you qualify for one quickly so you start selling almost immediately.)" Ads of this kind are directed to producers who have experienced a slump in earnings or whose employing firms are among those cutting back on offices, people and sales commissions. The impact of such advertising upon the ability of member firms to retain desirable salesmen would appear greater today than at any time in the recent past. Therefore, even firms which may not have a strong interest in developing an active insurance business may find themselves disadvantaged due to the NYSE's rigid policy against any involvement in such activity whatsoever.

Concerns of the NYSE

As noted heretofore, the provisions of Rule 318 have been cited by the Exchange as the basis for its stance on the issue of life insurance sales by members. The "primary purpose" doctrine underlying this Rule is the principal basis upon which the Exchange is relying in its efforts to exclude institutions from Exchange membership. The question which arises is whether the Exchange's position might not be seriously weakened in the event insurance sales were permitted and at some point this activity became the dominant type of business of one or more firms. With the weakening of the "primary purpose" doctrine, the Exchange might find itself unable to continue its resistance to institutional membership, with the result that this important and fundamental question may be resolved unsatisfactorily through evolution rather than on the basis of its own intrinsic merits.

Aside from this consideration, the Exchange position appears to reflect fear that expansion of member organizations into the insurance business would open up a Pandora's box of new problems for the membership as well as the Exchange itself. Maintenance of high standards of sales training and supervision might prove difficult. Compliance problems would be multiplied by the need for understanding and observing a body of generally unfamiliar regulations and by the necessity for establishing working relationships with new regulatory bodies.

Whether these concerns are sufficiently valid to justify the Exchange's apparent inclination to assign a low priority to this issue is a matter of opinion. All present indications are that top Exchange management is not likely to yield to anything less than strong, organized pressure to have the question presented to the Board for reconsideration at this time. Active interest on the part of the major firms in forcing the issue might be effective in this regard.

The Midwest Stock Exchange Position

In November, 1969, the Midwest Stock Exchange changed its rules to permit member organizations to engage in the sale of life insurance as an ancillary financial service to public customers. In taking this step, Michael E. Tobin, MSE president, said "It is our intention, in allowing member firms also to sell life insurance, to make it possible for them to offer a well-rounded, full-service financial program to their individual and institutional customers. Life insurance is an integral part of such a program."

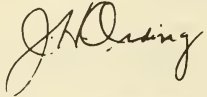
Membership response to this move has been encouraging but not overwhelming. According to Frank J. Rothing, Senior Vice President, 7 firms and 130 Registered Representatives have been cleared to sell life insurance, 7 additional firms have filed qualifying plans with the Exchange and are awaiting approval and 16 additional firms have asked for literature explaining the program. Plans to hold seminars around the country to promote the idea have been abandoned. Instead, a kit of materials has been prepared outlining the steps to be followed in seeking permission to sell insurance, registration and training requirements, State licensing laws and MSE surveillance procedures. The kit is made available to interested firms.

Conclusion

Many forces appear to be at work to break down traditional barriers to member firm involvement in financial areas other than stocks, bonds and commodities. The need for new sources of income, opportunities for diversification and freedom to compete effectively in a rapidly changing investment environment will ultimately create pressures for change to which the NYSE will have to respond, whether willingly or not. The question, then, is whether to move aggressively to accelerate such a development or to react only to situations as they arise in the normal course of events.

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The ASEF's Board of Governors has given the green light to the Committee on Life Insurance Sales to pursue this matter in any way it may see fit. The next step would seem to be the development by the Committee of a plan of action designed to organize membership interest in having the Exchange undertake a thorough and thoughtful study of the question with a view to NYSE Board action as soon as possible.

A handwritten signature in dark ink, appearing to read "J. H. O'Leary". The signature is fluid and cursive, with the first name "J." and last name "O'Leary" clearly distinguishable.

JHO:cb

June 24, 1970

RULE 345.17

17 Agreements.—Each prospective registered representative or officer shall sign the following statements:

(a) "I authorize and request any and all of my former employers and any other person to furnish to the Exchange, or any agent acting on its behalf, any information they may have concerning my credit worthiness, character, ability, business activities, general reputation, mode of living and personal characteristics, together with, in the case of former employers, a history of my employment by them and the reasons for the termination thereof. Moreover, I hereby release each such employer and each such other person from any and all liability of whatsoever nature by reason of furnishing such information to the Exchange or any agent acting on its behalf.

"Further, I recognize that I will be the subject of an investigative consumer report ordered by the Exchange and that I have the right to request complete and accurate disclosure by the Exchange of the nature and scope of the investigation requested.

(b) I authorize the New York Stock Exchange to make available to any prospective employer, or to any Federal, State or Municipal agency, any information it may have concerning me, and I hereby release the New York Stock Exchange from any and all liability of whatsoever nature by reason of furnishing such information.

(c) I agree that the decision of the New York Stock Exchange as to the results of any examinations it may require me to take will be accepted by me as final, and that I shall be subject to the penalties provided for under Rule 345(c) of the Board of Governors, as from time to time amended, if, in the opinion of the Exchange, I have

(1) violated any provision of the Constitution or of any rule adopted by the Board of Governors;

(2) violated any of my agreements with the Exchange;

(3) made any misstatements to the Exchange; or

(4) been guilty of (i) conduct inconsistent with just and equitable principles of trade, (ii) acts detrimental to the interest or welfare of the Exchange, or (iii) conduct contrary to an established practice of the Exchange.

(d) I have read the Constitution and Rules of the Board of Governors of the New York Stock Exchange and, if approved, I hereby pledge myself to abide by the Constitution and Rules of the Board of Governors of the New York Stock Exchange as the same have been or shall be from time to time amended, and by all rules and regulations adopted pursuant to the Constitution, and by all practices of the Exchange."

Further, each registered representative, in consideration of the Exchange's approving his application, shall sign the following statements:

(A) "That I will not guarantee to my employer or to any other creditor carrying a customer's account, the payment of the debit balance in such account, without the prior written consent of the Exchange.

(B) That I will not guarantee any customer against loss in his account or in any way represent to any customer that I or my employer will guarantee the customer against such losses.

(C) That I will not take or receive, directly or indirectly, a share in the profits of any customer's account, or share in any losses sustained in any such account.

(D) That I will not make a cash or margin transaction or maintain a cash or margin account in securities or commodities, or have any direct or indirect financial interest in such a transaction or account, except with a member organization or with a bank. I understand and agree that no such transaction may be effected and no such account may be maintained without the prior consent of my employer, and that except for Monthly Investment Plan transactions such employer must receive promptly, directly from the carrying member organization or bank, duplicate copies of all confirmations and statements relating to such transactions or account. I further understand and agree that I shall receive no compensation for commissions or profits earned on any transaction or account in which I have a direct or indirect financial interest, except with the approval of my employer and in accordance with the rules of the Exchange.

(E) That I will not rebate, directly or indirectly, to any person, firm or corporation any part of the compensation I receive as a registered employee, and I will not pay such compensation, or any part thereof, directly or indirectly, to any person, firm or corporation, as a bonus, commission, fee or other consideration for business sought or procured for me or for any member or member organization of the Exchange.

(F) That at any time, upon the request of the Department of Member Firms, or of any Committee or other Department of the New York Stock Exchange, I will appear before such Committee or Department and give evidence upon any subject under investigation by any such Committee or Department, and that I will produce, upon request of the Exchange, all of my records or documents relative to any inquiry being made by the Exchange.

(G) I understand that any changes in compensation in any form, or additional compensation in any form, may be subject to disapproval by the New York Stock Exchange, and that I may not be compensated for business done by or through my employer after the termination of my employment except as may be permitted by the Exchange.

(H) I agree that I will not take, accept, or receive, directly or indirectly, from any person, firm, corporation or association, other than my employer, compensation of any nature, as a bonus, commission, fee, gratuity or other consideration, in connection with any securities or commodities ~~transaction or transactions~~, except with the prior written consent of the Exchange.

or insurance

(I) I will notify the Department of Member Firms promptly if, during the tenure of my employment, I become involved in any litigation or if any judgments are found against me; or if my registration or license to sell or deal in securities ~~or to function as an investment advisor is ever refused, suspended or revoked~~; or if I become enjoined, temporarily or otherwise, from selling or dealing in securities ~~or from functioning as an investment advisor~~; or if I am arrested, summoned, arraigned or indicted for a criminal offense; or if I become involved in bankruptcy proceedings.

insurance or

insurance or

(J) I agree that any controversy between me and any member or member organization or affiliate or subsidiary thereof arising out of my employment or the termination of my employment shall be settled by arbitration at the instance of any such party in accordance with the arbitration procedure prescribed in the Constitution and rules then obtaining of the New York Stock Exchange."

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(K) If the Exchange, during the period of 30 days immediately following termination of my employment gives me written notice that the Exchange is making inquiry into any specified matter or matters occurring prior to termination of such employment, I agree that I will thereafter, comply with any request of the Exchange for me to appear and testify, submit records, respond to written requests, attend hearings, and accept disciplinary charges or penalties with respect to the matter or matters specified in such notice in every respect in conformance with the Constitution, Rules and practices of the Exchange in the same manner and to the same extent as required to do if I had remained an employee. If I refuse to accept such written notice or, having been given such notice, refuse or fail to comply with any such request of the Exchange, I agree that such refusal or failure may, in the discretion of the Exchange, act as a bar to future Exchange approval of my employment until such time as the Exchange has completed investigation into the matter or matters specified in such notice; has determined a penalty, if any, to be imposed against me; and until the penalty, if any, has been carried out.

Amendments.

February 3, 1966.

March 26, 1970.

December 1, 1970.

Effective April 1, 1971.

New York Stock Exchange Guide

Rule 345 ¶ 2345.17

NEW RULE 318.13

.13 Member organizations may engage in the sale of life insurance only through members, allied members or registered representatives who meet the licensing and other requirements of applicable insurance laws.

NEW YORK STOCK EXCHANGE, INC.

M E M O R A N D U M

November 18, 1971

TO: Board of Governors
FROM: Advisory Committee
SUBJECT: SALE OF LIFE INSURANCE BY MEMBER ORGANIZATIONS

The Advisory Committee has considered the staff memorandums dated November 9 and November 16, 1971 and recommends to the Board of Governors approval in principle - for discussion with the SEC staff and resubmission at a future meeting of the Board - of amendments to Rules 311, 318, 345.17(I) and 351 to permit the sale of life insurance by persons qualified to sell securities.

NEW YORK STOCK EXCHANGE, INC.
MEMORANDUM

November 16, 1971

TO: The Advisory Committee
FROM: Department of Member Firms
SUBJECT: Sale of Life Insurance by Member Organizations

In the event that the Board of Governors adopts the amendments to Rules 345.17(I) and Rule 311 and new Rule 351 on November 18, 1971 Exhibit II relating to the insurance memorandum should read as attached.

RULE 345.17

17 Agreements.—Each prospective registered representative or officer shall sign the following statements:

(a) "I authorize and request any and all of my former employers and any other person to furnish to the Exchange, or any agent acting on its behalf, any information they may have concerning my credit worthiness, character, ability, business activities, general reputation, mode of living and personal characteristics, together with, in the case of former employers, a history of my employment by them and the reasons for the termination thereof. Moreover, I hereby release each such employer and each such other person from any and all liability of whatsoever nature by reason of furnishing such information to the Exchange or any agent acting on its behalf.

"Further, I recognize that I will be the subject of an investigative consumer report ordered by the Exchange and that I have the right to request complete and accurate disclosure by the Exchange of the nature and scope of the investigation requested.

(b) I authorize the New York Stock Exchange to make available to any prospective employer, or to any Federal, State or Municipal agency, any information it may have concerning me, and I hereby release the New York Stock Exchange from any and all liability of whatsoever nature by reason of furnishing such information.

(c) I agree that the decision of the New York Stock Exchange as to the results of any examinations it may require me to take will be accepted by me as final, and that I shall be subject to the penalties provided for under Rule 345(c) of the Board of Governors, as from time to time amended, if, in the opinion of the Exchange, I have

(1) violated any provision of the Constitution or of any rule adopted by the Board of Governors;

(2) violated any of my agreements with the Exchange;

(3) made any misstatements to the Exchange; or

(4) been guilty of (i) conduct inconsistent with just and equitable principles of trade, (ii) acts detrimental to the interest or welfare of the Exchange, or (iii) conduct contrary to an established practice of the Exchange.

(d) I have read the Constitution and Rules of the Board of Governors of the New York Stock Exchange and, if approved, I hereby pledge myself to abide by the Constitution and Rules of the Board of Governors of the New York Stock Exchange as the same have been or shall be from time to time amended, and by all rules and regulations adopted pursuant to the Constitution, and by all practices of the Exchange."

Further, each registered representative, in consideration of the Exchange's approving his application, shall sign the following statements:

(A) "That I will not guarantee to my employer or to any other creditor carrying a customer's account, the payment of the debit balance in such account, without the prior written consent of the Exchange.

(B) That I will not guarantee any customer against loss in his account or in any way represent to any customer that I or my employer will guarantee the customer against such losses.

(C) That I will not take or receive, directly or indirectly, a share in the profits of any customer's account, or share in any losses sustained in any such account.

(D) That I will not make a cash or margin transaction or maintain a cash or margin account in securities or commodities, or have any direct or indirect financial interest in such a transaction or account, except with a member organization or with a bank. I understand and agree that no such transaction may be effected and no such account may be maintained without the prior consent of my employer, and that except for Monthly Investment Plan transactions such employer must receive promptly, directly from the carrying member organization or bank, duplicate copies of all confirmations and statements relating to such transactions or account. I further understand and agree that I shall receive no compensation for commissions or profits earned on any transaction or account in which I have a direct or indirect financial interest, except with the approval of my employer and in accordance with the rules of the Exchange.

(E) That I will not rebate, directly or indirectly, to any person, firm or corporation any part of the compensation I receive as a registered employee, and I will not pay such compensation, or any part thereof, directly or indirectly, to any person, firm or corporation, as a bonus, commission, fee or other consideration for business sought or procured for me or for any member or member organization of the Exchange.

(F) That at any time, upon the request of the Department of Member Firms, or of any Committee or other Department of the New York Stock Exchange, I will appear before such Committee or Department and give evidence upon any subject under investigation by any such Committee or Department, and that I will produce, upon request of the Exchange, all of my records or documents relative to any inquiry being made by the Exchange.

(G) I understand that any changes in compensation in any form, or additional compensation in any form, may be subject to disapproval by the New York Stock Exchange, and that I may not be compensated for business done by or through my employer after the termination of my employment except as may be permitted by the Exchange.

(H) I agree that I will not take, accept, or receive, directly or indirectly, from any person, firm, corporation or association, other than my employer, compensation of any nature, as a bonus, commission, fee, gratuity or other consideration, in connection with any securities or commodities transaction or transactions, except with the prior written consent of the Exchange.

~~(I) I will notify the Department of Member Firms promptly if, during the term of my employment, I become involved in any litigation or if any judgments are found against me; or if my registration or license to sell or deal in securities or to function as an investment advisor is ever refused, suspended or revoked; or if I become enjoined, temporarily or otherwise, from selling or dealing in securities or from functioning as an investment advisor; or if I am arrested, summoned, arraigned or indicted for a criminal offense; or if I become involved in bankruptcy proceedings.~~

(J) I agree that any controversy between me and any member or member organization or affiliate or subsidiary thereof arising out of my employment or the termination of my employment shall be settled by arbitration at the instance of any such party in accordance with the arbitration procedure prescribed in the Constitution and rules then obtaining of the New York Stock Exchange."

or insurance

See attached proposed
amendment of Rule
345.17(I)

New language underlinedPROPOSED AMENDMENT OF RULE 345.17(I)

Rule 345.17(I) I will notify my member organization and the Department of Member Firms promptly if, during the tenure of my employment I become the subject of: any investigation or proceeding by any governmental or securities or insurance industry self-regulatory body; a refusal of registration, injunction, censure, suspension, expulsion or other disciplinary action by any governmental or securities or insurance industry self-regulatory body; a major complaint by a customer of a member organization or by a broker-dealer in securities; a disciplinary action by a member organization; any litigation or arbitration alleging my violation of any agreement with or provision of any securities industry self-regulatory body's, constitution, by-laws, or rules or any securities or insurance law or regulation; or any bankruptcy or contempt proceeding, cease and desist order, injunction or civil judgment as party defendant; or any arrest, summons, arraignment, indictment, or conviction for a criminal offense (other than minor traffic violations); or any material allegation that I have conducted myself in a way which may be inconsistent with just and equitable principles of trade, or detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange; or if I violate any provision of the Exchange Constitution or of any rule adopted by the Board of Governors or of any securities or insurance law or regulation or of any agreement with the Exchange.

(K) If the Exchange, during the period of 30 days immediately following termination of my employment gives me written notice that the Exchange is making inquiry into any specified matter or matters occurring prior to termination of such employment, I agree that I will thereafter, comply with any request of the Exchange for me to appear and testify, submit records, respond to written requests, attend hearings, and accept disciplinary charges or penalties with respect to the matter or matters specified in such notice in every respect in conformance with the Constitution, Rules and practices of the Exchange in the same manner and to the same extent as required to do if I had remained an employee. If I refuse to accept such written notice or, having been given such notice, refuse or fail to comply with any such request of the Exchange, I agree that such refusal or failure may, in the discretion of the Exchange, act as a bar to future Exchange approval of my employment until such time as the Exchange has completed investigation into the matter or matters specified in such notice; has determined a penalty, if any, to be imposed against me; and until the penalty, if any, has been carried out.

Amendments.

February 3, 1966.

March 26, 1970.

December 1, 1970.

Effective April 1, 1971.

New York Stock Exchange Guide

Rule 345 ¶ 2345.17

NEW RULE 318.13

.13 Member organizations may engage in the sale of life insurance only through members, allied members or registered representatives who meet the licensing and other requirements of applicable insurance laws.

NEW RULE 351

Rule 351. Whenever any employee of a member or member organization who is registered with the Exchange, has ever been or becomes the subject of:

- a) any investigation or proceeding by any governmental or securities or insurance industry self-regulatory body; or
- b) a refusal of registration, injunction, censure, suspension, expulsion or other disciplinary action by any governmental or securities or insurance industry self-regulatory body; or
- c) a major complaint by a customer of a member organization or by a broker-dealer in securities; or
- d) a disciplinary action by a member organization; or
- e) any litigation or arbitration alleging the violation by the registered employee of any agreement with or provision of any securities industry self-regulatory body's, constitution, by-laws, or rules or any securities or insurance law or regulation; or
- f) any bankruptcy or contempt proceeding, cease and desist order, injunction or civil judgment as party defendant; or
- g) any arrest, summons, arraignment, indictment or conviction for a criminal offense (other than minor traffic violations); or
- h) any material allegation that he has conducted himself in a way which may be inconsistent with just and equitable principles of trade, or detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange; or

whenever any such registered employee has violated or violates any provision of the Constitution or of any Rule adopted by the Board of Governors or of any securities or insurance law or regulation or of any agreement with the Exchange, such employee shall promptly notify his employer thereof.

Whenever a member or member organization has knowledge that any of his or its registered employees is required to give the notice required hereby, such member or member organization and such employee shall promptly notify the Exchange of such matter.

RULE 311 New language underlined

.10 (i) Each member, allied member, approved person or member organization shall promptly report to the Secretary of the Exchange whenever any one of them becomes the subject of:

- (a) an investigation or proceeding by any governmental or securities or insurance industry self-regulatory body;
- (b) a refusal of registration, injunction, expulsion, suspension, censure or other disciplinary action taken by any governmental or securities or insurance industry self-regulatory body;
- (c) any litigation, as a defendant, involving alleged violation of any agreement with or provision of a securities industry self-regulatory body's constitution, by-laws or rules or any securities or insurance law or regulation;
- (d) any bankruptcy or contempt proceeding, cease and desist order or injunction;
- (e) any arrest, summons, arraignment, indictment or conviction for a criminal offense (other than minor traffic violations);
- (f) a major complaint by a customer of a member

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organization or another broker-dealer in securities.

(ii) In addition, each member organization shall inform the Secretary of the Exchange whenever any member, allied member or approved person of such member organization has:

- (a) been the subject of a disciplinary action by the member organization;
- (b) violated any provision of the Exchange Constitution or Rules or any securities or insurance law or regulation;
- (c) violated any agreement with the Exchange; or
- (d) conducted himself (herself) in a way which may be inconsistent with just and equitable principles of trade, detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange.

Senator WILLIAMS. In reaching a decision on this particular matter, did you see any interest that should have been considered other than the interest of the members of the exchange?

Mr. CALVIN. Certainly. I certainly do. In that connection, I also would like to point out that at that time the Board acted preliminarily—that was in November of last year—they did not adopt these recommendations, but rather approved them in principle for submission to the SEC.

At that time, that is, on November 18 of last year, the Stock Exchange also made a public announcement of this proposed action, in a news release which I have here captioned "Brokers Get Approval to Sell Life Insurance." It discusses the action taken that very day by the Board.

We did not on this occasion, although we have on other occasions, in so many words solicited public comment, but as a result of the wide dissemination of this news release, we did in fact receive comments, as Mr. Arning has stated, from interested persons outside the securities industry.

Also, I might say that since this time, I believe it has been since this time, the SEC has now made its Rule 17a-8 filing a public file. I think that is correct.

Mr. LOOMIS. We have since March made all exchange filings under 17a-8 a matter of public record, as well as any definitive response thereto.

Mr. CALVIN. If I may say one more thing, and this relates to one of the questions in the staff paper regarding making public proposed rules of the exchange.

We—that is, Mr. Haack and myself—appeared before the House Subcommittee on Commerce and Finance last November, and at that time we endorsed the view that, and I am reading now, "all proposed rules of national securities exchanges be publicized by the SEC, that important rules be the subject of SEC public hearings or that the Commission solicit comments on proposed exchange rules; and, that the SEC should write an opinion articulating its findings and reasons," and so forth.

At that time we were speaking to a similar question as is in the staff case study here as to our views on a recent note in 80 Yale Law Journal 811 (1971) talking about the decision making process at the administrative agencies. We said, "We would support such a procedure and would welcome it."

"Our only concern," we said, was "that any new procedure would not delay necessary action by the Exchange or hamper the Exchange from acting expeditiously when circumstances require prompt, decisive action."

I am referring to page 1736 of the House Subcommittee on Commerce and Finance hearing record on the study they have been conducting of the securities industry.

Senator WILLIAMS. What was the date on that?

Mr. CALVIN. This appears on page 1736 of part 3 of the Subcommittee hearing record, and I don't have the exact date. It was November of 1971.

I might say that following this, we did in what we thought areas that were appropriate, particularly in connection with institutional

membership, new auditing standards for member firms, and also in connection with the release on life insurance, but more importantly in the first two items I mentioned, solicit public comments on those proposals as well as membership comment.

You see, our problem here has been, as Mr. Arning has said, that we have in the past and most notably in 1969, I believe it was—in connection with our development of proposals related to the public ownership of member firms—sent proposals out for public comment.

We made a distribution at that time, as I recall, of over 10,000 mailings to individuals, organizations, et cetera, as well as giving wide publicity to the proposals.

We received very few comments as a result of that mailing. This would have been in September of 1969, I believe.

A couple of months later, the Commission, the SEC, of its own initiative sent out that same document for public comment. They received a substantial number of public comments on the same proposals. What we have suggested in this reference that I have made to our appearance before the House is that the Commission make the decision as to whether public comments should be solicited, whether public hearings should be held and that type of thing, since they are viewing not only proposed rule changes of the New York Stock Exchange but other exchanges as well.

I think the SEC is moving in this direction because in recent months, as Mr. Loomis has said, they have established a public file for all of these filings.

So if you, or I, or anyone in the room wants to know what recent rule proposals the New York Stock Exchange has made, all you have to do is walk over to the SEC office and look at the file.

Senator WILLIAMS. I would like to compare the New York Stock Exchange's procedures with those of the Midwest Exchange. The end result was the same, to permit diversifications, but, I don't know what differences there were in the procedures used in arriving at the decision. The result, or the method of diversifying certainly is different between the Midwest and the New York, and as I understand our study, the limitations or the requirements on members in order to sell are far more precise than members of the New York Stock Exchange. Am I accurate on that? You have programs to qualify members to sell.

Mr. TOBIN. I think that is a fair statement, Mr. Chairman.

Senator WILLIAMS. How did you approach this decision?

Mr. TOBIN. I can track through the chronology of our decision for you.

Over the course of, I gather a number of years, actually before my involvement with the Exchange, we had sporadic inquiries on the part of member firms as to whether it would be possible for them to sell life insurance. I am not privy to what answers were given and so on, but in effect the exchange had a policy which did not permit the sale of life insurance.

Along about 1968, the level and frequency of these inquiries increased somewhat to the point where we felt a study should be made by competent professionals as to member attitudes, business problems, and regulatory problems that might pertain if we permitted the sale of life insurance.

To that end, we employed outside consultants who were insurance experts. We conducted personal interview surveys of a goodly number of our members and supplemented that with questionnaire surveys to our entire membership.

In general, the results of those surveys indicated that the membership broke down into two broad groups, those who had no interest themselves in taking on the function of selling life insurance and other firms who had a very decided interest.

To my recollection, in no case did a firm that wasn't interested in the sale of insurance in their own firm recommend against allowing other firms to engage in this activity.

From this point, our consultants drafted up a program of how they conceived we could best pursue allowing member firms to sell insurance. That was initially presented to our executive committee and secondly to the full board, and in both cases we received approval to go ahead to the next phase in working out a detailed program.

As part and parcel of our philosophy on the Midwest Exchange, we are interested in encouraging to the maximum extent possible professionalism on the part of our members and their salesmen.

In order to do that, we operate our own registered representative training programs, and we felt that, given our interest in our total members activities, it would be appropriate for us to extend this concept into the sale of life insurance.

To that end, we set up training programs for the qualification of RR's. We have examinations in that connection for qualification.

We insist that our members utilize a carrier which has a Best approval.

We conduct our normal member firm examination and surveillance efforts relative to member firms activities in the life insurance area, and in general treat this area very much as we handle our surveillance function, and self-regulatory function, if you will, in the securities area.

Senator WILLIAMS. I appreciate that.

I wonder if I could address this to Commissioner Loomis.

In February of 1972, the SEC wrote to the New York Stock Exchange stating that the Commission believed, and this is what it said, that an "adequate self-regulatory program should be presented before the exchange permits its members to proceed with this new activity."

Now, I gather that the SEC stopped there, and you described the limitations you felt, Commissioner Loomis, and the reasons why you were limited.

Do you feel that this was an area where you might appropriately have suggested or, maybe more strongly, made it necessary that self-regulation be put on an equal basis?

You had two exchanges here, two major exchanges, one with a formalized program of entry into this new activity, and the other coming in without a formalized training program, et cetera.

Did you feel that there might be a basis for a principle of equal regulation within these self-regulatory organizations?

Mr. Loomis. Well, I am not sure that as far as we are concerned we didn't feel that we were in a position to tell either of them what their

regulatory program should be, for the reasons which I have outlined above.

This letter which you referred to followed an earlier letter, and also we had advised the Midwest Stock Exchange of the New York Exchange's proposal. We had made sure that the New York Exchange knew what the Midwest Stock Exchange program was, and we had directed their attention specifically to that program, and they had replied saying, in effect, that they did not believe they wished to undertake such a program.

Senator WILLIAMS. When the Commission said "an adequate self-regulatory program," what did the Commission have in mind?

Mr. LOOMIS. Well, the Commission had in mind just that. We had called their attention to the program of the Midwest.

Senator WILLIAMS. You thought the Midwest was an adequate program?

Mr. LOOMIS. We thought the Midwest was an adequate program. They did not disagree with that, but they said they didn't think in their view, as I recall, that under the circumstances all this was necessary or desirable.

So we in effect were saying, in view of the limitations in our jurisdiction, if you feel that you have to devise your own program, we believe it should be an adequate one.

Senator WILLIAMS. We will have to recess.

I am mindful of your schedule, and I will be right back.

(Recess.)

Senator WILLIAMS. I think we can boil down our inquiry now to some basics.

Commissioner Loomis, I think the discussion here indicates the need to put this question to you. Member firms are getting into new areas. This inquiry today suggests that there is an area where the exchange has no oversight authority—the Commission has no oversight authority, excuse me.

I am wondering about this question of whether in these areas where the Commission does not have authority, do we not have a gray area? What can you do about it?

Mr. LOOMIS. There is a gray area here. I think in general, that we have authority, oversight authority, though I have indicated our methods of exercising it and our tools are not wholly adequate, and we suggested, as I mentioned yesterday, some legislation in that area.

The gap between our total concern and the activities of the exchanges is not normally very great because practically everything they do in their capacity as an exchange we have some authority over.

But, as I say, the procedures and the scope of it are uncertain. But here we had a special case of another Federal statute which had an impact and reduced our authority below what it otherwise might be.

I think Mr. Cohen might have a comment or two on that, also.

Mr. COHEN. Senator—

Senator WILLIAMS. This is self-regulation in the securities industry that requires governmental oversight, but we do not appear to have it in this particular area?

Mr. COHEN. That is right. I think your point is borne out rather dramatically by a quotation that appeared on page 10 of your staff

study report, where there is a letter from the SEC to the Midwest referring to insurance. I will not quote the whole thing, but it talks about reevaluating the procedures for supervision of salesmen "with a view to providing adequate regulation and supervision . . . in accordance with the Exchange's responsibility to fulfill its self-regulatory duties."

So here is the Commission telling the Exchange it does have self-regulatory duties in this area. I certainly do not quarrel with Mr. Loomis—I have not looked into it as a legal question—but if the Commission cannot get into insurance matters, because of the McCarran Act, we have a case where oversight just is not as broad as self-regulation. Speaking personally, and I think it would also be the Midwest's position, it seems to me it is wrong any time you have self-regulatory authority or responsibility without Commission oversight.

It is wrong, first, because you need that oversight to keep self-regulation working right, and second, because of the antitrust overtones that you run into when you have self-regulation without Commission oversight.

So I would certainly say that, to the extent a subject like insurance is within the scope of self-regulation but not within the scope of supervision or oversight by the Commission, there is a gap there that ought to be repaired.

Mr. CALVIN. I might add the observation, Mr. Chairman, that, however, we all know that the area of life insurance is not an unregulated area. While it may be true that the SEC does not have the authority to regulate it, it is in fact regulated by the States and historically has been regulated by the States.

Senator WILLIAMS. Yes, we appreciate that of course. If this is anything comparable to another situation we found, State insurance regulatory bodies probably feel this is a SEC matter, and the SEC thinks it is State, and in the meantime, true oversight falls right between these regulatory agencies.

What, for example, was demanded of the New York Stock Exchange by the New York State Department of Insurance?

Mr. CALVIN. Before I answer that, and I would ask Mr. Arning to answer it, I want to add one final sentence as a closing to what I was saying. That is, that the New York Stock Exchange clearly feels that it does have self-regulatory authority in this area, and so to that extent, even though the SEC may not possess the authority because of problems with the McCarran Act, the Exchange took the view, and it is so stated in the November 9 staff memorandum to the Board, that this was an area where the Exchange has self-regulatory authority.

Senator WILLIAMS. That is not in conflict with Mr. Cohen's statement?

Mr. CALVIN. No; I am agreeing with Mr. Cohen on this point.

Mr. ARNING. By virtue of the fact that we have extensive record-keeping requirements, training requirements, and data that is part of our files, notwithstanding what may be an absence of legislative background, the Securities and Exchange Commission in its oversight of us has access to all this information that is in our records.

You asked a question earlier about what we were required to do with New York State. The Exchange, as an institution, has no requirement with New York State. Any member organization who licenses

any of its personnel must license them under the State, and the carrier they are selling must be licensed under the State insurance laws. But as the New York Stock Exchange—as far as it is concerned, there is no requirement.

Senator WILLIAMS. In other words, the State authority does not reach beyond the insurance company; is that what you are saying?

Mr. ARNING. It reaches to the individual, right through us, if I can use that as an analogy. They can get to an insurance salesman who is a registered representative of mine who violated any of the concepts or regulations of New York State law directly, and indeed, in our conversations with the commissioner, he would do so, should the circumstances arise.

Senator WILLIAMS. Do you know as a matter of detail, whether they did reach the members who availed themselves of this opportunity?

Mr. ARNING. There are members of the New York Stock Exchange who are licensed under New York State laws; yes. And in fact, anyone who is selling in New York, under our rule would have to. That is two points.

Senator WILLIAMS. How does that work? You have New York Stock Exchange members selling insurance of companies that are not New York State companies.

Do other States reach your members?

Mr. ARNING. Yes, sir; under the same technique.

Mr. COHEN. Senator, if I may add one thought to my previous comment, I am not prepared personally to say that Commissioner Loomis' statement about the McCarran Act's application here is the only possible way of reading the situation.

I think that insurance selling through member firms may become sufficiently intertwined with securities selling so that those involved with securities regulation may have some concern, and the SEC has expressed some concern as to how this was to be handled.

So I don't know that we can resolve today exactly how the McCarran Act impinges on this. But if it is true that the McCarran Act leaves a gap in the scope of oversight in relation to self-regulatory responsibility, then I think that is the kind of a gap that ought to be looked at to be sure that oversight is as broad as the self-regulatory functioning.

Mr. CALVIN. I was going to say that Mr. Cohen and Mr. Loomis know there are other areas where a similar situation exists.

I know from my own experience, for example, when the Congress changed the tax laws to provide a more advantageous tax treatment for real estate investment trusts, the SEC felt it did not have the authority to impose the type of regulations that those new investment media required. A lot of people thought, myself included, and I think probably Mr. Cohen and Mr. Loomis included, felt more was required than disclosure in the area of real estate investment trusts, which was the limit of SEC authority.

What happened was that the States stepped in through the State securities commissioners. They promulgated detailed requirements regulating the way these real estate investment trusts operate. The States filled this Federal regulatory void. As a result it has not been necessary for the Congress to convey authority to the SEC to regulate real estate investment trusts.

I don't know that it has ever been seriously recommended that Congress do so. In other words, the State regulation of securities came in and filled the regulatory gap as it does in the insurance area.

The point is that sale of life insurance is not the only area where the SEC may lack regulatory authority.

One other thing I might say before we get off the subject is that after the rule that we have been discussing was adopted finally, the department of member firms of the exchange under the direction of Mr. Bishop issued a circular on April 4 to all of the exchange's members which included not only the text of the new rules, but also outlined in detail the requirements that member firms were expected to meet with respect to the sale of life insurance.

These include, and I am reading, now, "These persons must be licensed to sell life insurance in each State in which they offer life insurance." The rule requires "that each member organization report to the exchange each person through whom life insurance will be sold, the training in the sale of life insurance received by each such person, the State or States in which he is licensed to sell life insurance and the name or names of the life insurance companies for which each such person is licensed," and so forth.

The circular goes into even more detail. It spells out the type of supervision, surveillance, and records which member firms are expected and required to keep under the rules. It admonishes them to demonstrate the steps taken to satisfy themselves that the insurance carriers that they are utilizing have a satisfactory operational and financial capability.

In other words, this circular spells out in detail, I submit, a regulatory program in this area. It is not identical to that of others, but it certainly is a regulatory program. You might want to consider including this circular of April 4, which is Member Firm Educational Circular 569, in the record.

Senator WILLIAMS. We would like to have it for the record.

(The document referred to follows:)

M. F. EDUCATIONAL CIRCULAR No. 569

NEW YORK STOCK EXCHANGE, INC.,
DEPARTMENT OF MEMBER FIRMS,
April 4, 1972,

To : Managing partner/chief executive officer

Subject : Permissive sale of life insurance amendments to Rules 311, 318, 345.17 and 351

At its meeting on March 16, 1972 the Board of Governors amended Rules 311, 318, 345.17(H) & (I) and 351 to permit member organizations to sell life insurance directly or through a corporate affiliate or subsidiary. Member organizations may commence the sale of life insurance only after complying with the new rule requirements. Copies of the amendments to these Rules are attached. In adopting its rule amendments the Board imposed certain limitations designed to assure a controlled entry into the insurance field as described below :

Member organizations are limited to acting as agent in the sale of life insurance with premium checks made payable to the policy writing insurance company. They are not permitted to underwrite insurance. They may become general agents or brokers, provided this does not involve having premium checks made payable to them. The Exchange will consider individual requests from member organizations to handle premiums and perform other operational functions. Such requests should include detailed plans and a description of the qualifications and experience of personnel.

The Exchange desires its member organizations to sell only the life insurance products of financially and operationally responsive insurance carriers. Accordingly, a member organization should be prepared to demonstrate the steps taken to satisfy themselves that such insurance carriers as they utilize have a satisfactory operational and financial capability.

Rules 318.13(1) (2) and (3) require the maintenance of the following information relating to supervision, surveillance and records:

Supervision

- (a) names of persons supervising insurance salesmen
- (b) specific responsibility of each
- (c) description of supervisory program related to sale of life insurance

Surveillance

- (a) description of life insurance surveillance program
- (b) names of persons responsible for surveillance of life insurance activities
- (c) responsibilities of each such person

Records

- (a) copies of all complaints and correspondence
- (b) record of all NYSE commissions generated on portfolio sales for any insurance carriers whose policies are sold
- (c) commissions earned on sale of life insurance
- (d) face value of life insurance sold
- (e) life insurance commissions paid to registered representatives

Member organizations will be expected to maintain such records on a current basis and retain them for at least 3 years in a reasonably accessible location for inspection by the Exchange at least annually.

Only life insurance may be sold under the amended Rules. Accident and health insurance are not included nor is any form of property insurance. Variable annuity contracts may also be sold by member organizations.

The sale of life insurance may be conducted only through members, allied members and registered representatives who are qualified to sell securities. These persons must be licensed to sell life insurance in each state in which they offer life insurance. Rule 318.13 requires that each member organization report to the Exchange each person through whom life insurance will be sold, the training in the sale of life insurance received by each such person, the state or states in which he is licensed to sell life insurance and the name or names of the life insurance companies for which each such person is licensed.

Experienced persons from the life insurance industry employed by member organizations to sell life insurance must be approved as registered representatives. Many such persons have already qualified as NASD registered representatives and will not be subject to the six month training period required for persons with no prior securities experience. For such persons a prompt submission of the RE-1 application form is essential to permit an early start of the Exchange's customary background investigation. These persons will be permitted to sell insurance immediately but must be approved and pass the registered representative examination within 6 months, and may not sell securities until that time.

As with commissions and other forms of securities compensation, insurance commissions must be paid to the member organization employer, not the individual salesman. Member organizations may arrange for their employees to receive a share of premium commissions. The amount of this share will be at the discretion of the member organization employer.

An insurance salesman cannot sell insurance for a member organization under a certificate of convenience license. A member organization may conduct its life insurance business through an unaffiliated general agency or broker rather than dealing directly with the insurance carrier provided the member organization meets all of the requirements of the amended rules.

In addition to the specific limitations described above, member organizations are reminded that under Rule 342 they are at all times responsible for the supervision and control of each department or business activity and under Rule 401 for adherence to good business practices in each business activity. These requirements apply to the sale of life insurance as well as to the sale of generally recognized securities products.

Member organizations are also reminded that the income derived from the sale of life insurance will not be considered acceptable income when computing a member organization's compliance with Rule 318.

All questions and reports to the Exchange concerning the sale of life insurance should be directed to Mr. Richard A. Greves, Assistant Director, Department of Member Firms, 4 New York Plaza, New York, N. Y. 10004, Telephone (212) 623-5058.

DAVID D. HUNTOON,
Associate Director.

RULE 311 NEW LANGUAGE IN ITALIC

10. (i) Each member, allied member, approved person or member organization shall promptly report to the Secretary of the Exchange whenever any one of them becomes the subject of:

(a) an investigation or proceeding by any governmental or securities or *insurance* industry self-regulatory body;

(b) a refusal of registration, injunction, expulsion, suspension, censure or other disciplinary action taken by any governmental or securities or *insurance* industry self-regulatory body;

(c) any litigation, as a defendant, involving alleged violation of any agreement with or provision of a securities industry self-regulatory body's constitution, by-laws or rules or any securities or *insurance* law or regulation;

(d) any bankruptcy or contempt proceeding, cease and desist order or injunction;

(e) any arrest, summons, arraignment, indictment or conviction for a criminal offense (other than minor traffic violations);

(f) a major complaint by a customer of a member organization or another broker-dealer in securities.

(ii) In addition, each member organization shall inform the Secretary of the Exchange whenever any member, allied member or approved person of such member organization has:

(a) been the subject of a disciplinary action by the member organization;

(b) violated any provision of the Exchange Constitution or Rules or any securities or *insurance* law or regulation;

(c) violated any agreement with the Exchange; or

(d) conducted himself (herself) in a way which may be inconsistent with just and equitable principles of trade, detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange.

NEW RULE 318.13

A member organization may engage in the sale of life insurance (directly, or through its corporate affiliate or subsidiary) only through one or more members, allied members and registered representatives of such member organization each of whom is then in compliance with the licensing and any other requirements of applicable insurance laws and regulations.

Each member organization which engages in the sale of life insurance shall promptly report to the Exchange the name of each person through whom such member organization sells life insurance, the training in the sale of life insurance received by each such person, the state or states in which each such person is licensed to sell life insurance and the names of the life insurance companies for which each such person is licensed in each such state.

Each member organization which engages in the sale of life insurance shall also keep current in a separate file within the member organization the following information:

(1) a description of the member organization's supervisory program as related to the sale of life insurance, the name of each member, allied member or employee within the member organization who has been given the responsibility of exercising supervisory control over the persons engaged in the sale of life insurance and the specific responsibilities of each such person.

(2) a description of the member organization's surveillance program as related to the sale of life insurance, the name of each member, allied member or employee within the member organization who has been given the responsibility of exercising surveillance responsibilities and the specific responsibilities of each such person.

(3) sales and other records relating to the member organization's sale of life insurance as deemed appropriate by the member organization including, without limitation, records disclosing the types and amounts of life insurance sold, the commissions earned and the commissions paid to individuals engaged

in the sale of life insurance. Such records shall be maintained in a reasonably accessible location for inspection by the Exchange for not less than three years.

RULE 345.17 NEW LANGUAGE IN ITALIC, OLD LANGUAGE IN BRACKETS

(H) I agree that I will not take, accept, or receive, directly or indirectly, from any person, firm, corporation or association, other than my employer, compensation of any nature, as a bonus, commission, fee, gratuity or other consideration, in connection with any securities, [or] commodities or insurance transaction or transactions, except with the prior written consent of the Exchange.

RULE 345.17 (I) NEW LANGUAGE IN ITALIC

Rule 345.17(I). I will notify my member organization and the Department of Member Firms promptly if, during the tenure of my employment I become the subject of: any investigation or proceeding by any governmental or securities or insurance industry self-regulatory body; a refusal of registration, injunction, censure, suspension, expulsion or other disciplinary action by any governmental or securities or insurance industry self-regulatory body; a major complaint by a customer of a member organization or by a broker-dealer in securities; a disciplinary action by a member organization; any litigation or arbitration alleging my violation of any agreement with or provision of any securities industry self-regulatory body's, constitution, by-laws, or rules or any securities or insurance law or regulation; or any bankruptcy or contempt proceeding, cease and desist order, injunction or civil judgment as party defendant; or any arrest, summons, arraignment, indictment, or conviction for a criminal offense (other than minor traffic violations); or any material allegation that I have conducted myself in a way which may be inconsistent with just and equitable principles of trade, or detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange; or if I violate any provision of the Exchange Constitution or of any rule adopted by the Board of Governors or of any securities or insurance law or regulation or of any agreement with the Exchange.

RULE 351. NEW LANGUAGE IN ITALIC

Rule 351. Whenever any employee of a member or member organization who is registered with the Exchange, has ever been or becomes the subject of:

- (a) any investigation, or proceeding by any governmental or securities or insurance industry self-regulatory body; or
- (b) a refusal of registration, injunction, censure, suspension, expulsion or other disciplinary action by any governmental or securities or insurance industry self-regulatory body; or
- (c) a major complaint by a customer of a member organization or by a broker-dealer in securities; or
- (d) a disciplinary action by a member organization; or
- (e) any litigation or arbitration alleging the violation by the registered employee of any agreement with or provision of any securities industry self-regulatory body's, constitution, by-laws, or rules of any securities or insurance law or regulation; or
- (f) any bankruptcy or contempt proceeding, cease and desist order, injunction or civil judgment as party defendant; or
- (g) any arrest, summons, arraignment, indictment or conviction for a criminal offense (other than minor traffic violations); or
- (h) any material allegation that he has conducted himself in a way which may be inconsistent with just and equitable principles of trade, or detrimental to the interest and welfare of the Exchange, or contrary to an established practice of the Exchange; or

whenever any such registered employee has violated or violates any provision of the Constitution or of any Rule adopted by the Board of Governors or of any securities or insurance law or regulation or of any agreement with the Exchange, such employee shall promptly notify his employer thereof.

Whenever a member or member organization has knowledge that any of his or its registered employees is required to give the notice required hereby, such member or member organization and such employee shall promptly notify the Exchange of such matter.

Senator WILLIAMS. Mr. Tobin?

Mr. TOBIN. I would have to say from the Midwest point of view,

the point Mr. Calvin makes about the States stepping in and offering adequate oversight is not a position we adhere to.

I think it is implicit in Mr. Cohen's comments, and in some other discussions we have had here today, that the securities industry is in a very rapidly changing mode.

As such, if the Commission does not have oversight responsibility under existing legislation, I think that is an area that should be looked at so that we don't have these gaps; and I personally do not believe that comparable oversight is afforded, given the widely varying State regulations that obtain across the country.

Mr. LOOMIS. If I could just respond briefly to what Mr. Calvin said about real estate investment trusts. It is true that they are not regulated as investment companies under the Investment Company Act of 1940. They are exempt from that type of regulation.

But we have no doubt as to our ability to exercise oversight over the activities of exchange members in dealing with those securities.

Senator WILLIAMS. That whole colloquy was very useful, I appreciate it.

Finally, I wonder about any basic policy that the SEC has or the exchanges have as to what types of activities members should be permitted to engage in. Is there a basic and overriding policy?

I wonder if there is any policy meaning to be supplied behind the rule.

Mr. ARNING. Mr. Chairman, let me respond to that by pointing out what I think was part of the original staff comments that Mr. Harris presented earlier, kind of a basic identification we have given to "kindred activities," which is the placement and protection of financial resources.

Now that has indeed been limited to the area of the "kindred" activities. It is the one area where we are seeing a good deal, and we have in the past few years as well, concentration of effort, where a range of services can be provided under perhaps one roof. Now that area, I don't think one can quarrel with.

It is fairly definitive. To be sure, we did not have real estate investment trusts too long ago, and we do have them now, and they fit into this area of definition, but I think as a rule of thumb that type of approach to this question is the only valid way you can look at it.

We have had some unusual examples in the past, but I think they are rare rather than indicative of any general trend.

Mr. LOOMIS. All I would say on that was that as Mr. Arning has indicated, the exchanges, particularly the major ones, have tended to limit their member firms to activities which you might say are related or, "kindred," or however you wish to put it, to the securities industry and the securities brokerage function, or the securities market function, and we have not found it necessary to develop for ourselves an independent overall policy as to activities that member firms should be allowed to engage in, and there is a question as to whether they should be more restricted in diversification than nonmember firms who sometimes get even more diversified.

But in view of the tendency toward diversification in the financial community, which has been going on very rapidly, and which is probably the stimulus for the New York Stock Exchange's decision here,

I think it is a matter that the Commission should take another look at, and I hope your Committee will, too.

Mr. TOBIN. Speaking for the Midwest on this subject, I am not sure whether I am at variance with Mr. Arning's statement or not, but from our point of view, we would opt for flexibility in this area of deciding what is "kindred" and what is not.

Admittedly the Midwest Stock Exchange does not operate on a precisely defined basis, in the determination of what is "kindred."

Senator WILLIAMS. Do you have a "kindred" rule, too?

Mr. TOBIN. In effect. It is a policy of the exchange. It gears in with the thrust toward encouraging and in fact insisting upon professionalism and full time participation and so on.

But I think a practical, workable approach encompasses, among other things, determining customer demand and the appropriate professional level to which a member firm should operate and then judging any particular field of business that is related to financial services, as an individual case. Thus, I would not work with precise definitions.

So that I personally would opt for doing this on a case-by-case basis with some flexibility.

Senator WILLIAMS. I have appreciation for that. Of course, it is of interest to us, too, how the procedures under which the cases are decided operate.

Mr. TOBIN. True.

Senator WILLIAMS. One of the surprises that comes to me is that a major decision of new business activity did not go to membership for its individual votes.

Am I right on that? It was a Board of Governor's decision?

Mr. ARNING. Yes, Mr. Chairman, you are correct. These were rule changes. If changes in the Exchange's constitution had been required, it would have been necessary to have a membership vote.

As we pointed out earlier, there was an ample opportunity for the industry at large to comment to us, and there was an extensive amount of work done by the association in developing their recommendation. I can hardly believe that the membership for some years wasn't well aware of what was going on.

Senator WILLIAMS. Do you gentlemen see this question of more diversification of business opportunities before you as a continuing question?

Mr. ARNING. Yes.

Mr. TOBIN. I would think so.

Senator WILLIAMS. Are we going to get into another one of these percentage things? [Laughter.] Are we going to find ourselves strait-jacketed by the percentage formula?

You know, we have had these discussions in another context, but this was what it was all about, just what part of the activity the broker-dealer was in the public business of securities.

Mr. COHEN. Senator, as that 80-20, or in the Midwest case, 50-50, formula developed, it goes to what part of the securities business must be for public customers as distinguished from affiliates. It is a related question, but it doesn't really go to what part of the business of a firm must be this or that kind of securities, or this or that kind of kindred business.

Senator WILLIAMS. I appreciate it, but it is all within securities, but it is the same kind of question, in a way. The broker is there to

serve the public, and he has to be 80 percent with the public and only 20 percent affiliated.

Mr. COHEN. It is based on a different philosophy, though, sir, which is that if you have a public marketplace, the question is whether someone should be in that marketplace who doesn't have either a function within the marketplace or a public brokerage business.

Now, whether that public business must be predominant 80 percent or predominant 51 percent or some other percentage is a separate question, but it goes to a philosophy as to whether firms that are members and admitted to the privilege of membership should be able to do primarily their own business as distinguished from primarily serving a public function. I do think those are separate issues.

Senator WILLIAMS. They are, and I was using the percentage to suggest that we might have a similar question on the percent of activity that might be not directly related to the securities business.

Mr. LOOMIS. I tend to concur. You tend to reinforce my position to concur with Mr. Tobin that we had better not get this too mathematical.

Mr. TOBIN. If I may, sir, I would like to give our experience by way of an amplification of a comment Mr. Arning made.

I have not noticed, at least in my personal contacts with insurance companies, any great resentment on the part of these companies directly toward the brokers getting involved in the sale of insurance. Rather, what I have noticed is that many of these companies at least view this as an arm in their distribution. I think that is what you are trying to say.

Mr. ARNING. That is correct.

Mr. TOBIN. At least that is a personal experience with some of them.

Senator WILLIAMS. I am sure that the different views of the changes between 1965 and 1970 had something to do with the harder times that the brokers were having. It was an economic question in part.

Mr. CALVIN. Yes, it was.

Mr. ARNING. I would say, Mr. Chairman, there was a good deal of what we define as external influences on this. Competition is one. If you are located in Richmond, Va., where you had fine substantial organizations competing against you, and you had declining revenues of your own, you are going to feel this, and you are going to react in a way that is totally predictable.

Mr. CALVIN. What might be helpful on this point is to refer again to this staff memorandum which was submitted to the Exchange's Board on the sale of life insurance. Included as a part of the memorandum is a copy of a survey which had been done by the then Association of Stock Exchange Firms in August 1970. The ASEF, which is now the Securities Industry Association, did a survey of their members, which at that time was identical to the membership of the New York Stock Exchange.

They had 202 firms responding, asking if they felt the NYSE should broaden its rules to permit interested member organizations to sell life insurance. These are all member organizations of the New York Stock Exchange.

Their survey, as shown in the November 9, 1971, memorandum to our Board, reported that 55 percent were in favor, 27 percent against, and the rest had no opinion. However, when the member firms were asked "if you were permitted to sell life insurance, would you?" the percentages increased.

The members of the Exchange were not asked to vote on this subject prior to final board approval, and they did not, because it was not a constitutional issue, but rather was only a rule change. However, the ASEF had, prior to the board's action, solicited the views of our membership, which is also their membership, and had made that survey available to the board through the staff memorandum.

Also, I think that this whole area is in its broader context one that is in the process of rapid change at the New York Stock Exchange.

Mr. Arning mentioned in his opening remarks that the New York Stock Exchange now has a board of 21 members, 10 of whom are representatives of the public, and 10 from the industry. Also, for the first time the Exchange will have a full-time paid chairman, Mr. James J. Needham, who will assume office later this month.

We—that is, Mr. Bishop, Mr. Arning, and I, and other members of the exchange staff—have had an opportunity to participate in the two meetings the new board has held, the most recent being last Thursday.

I think it is obvious that the whole atmosphere is going to be much more public oriented as a result of this reorganization than it has been in the past.

You know this developed as a result of Mr. William McChesney Martin's recommendations. I think even apart from the reorganization, the move clearly was to a greater public orientation in the realm of the stock exchanges, both the New York Exchange and the other exchanges.

We have, as I said before, made a recommendation to the House subcommittee last year which, in effect, would provide for greater public participation in our rulemaking procedures.

We voluntarily have followed that recommendation. Most recently, it was on April 20 of this year, when we circulated the new membership and audit standards for public comment. We did receive a lot of thoughtful comments which have been helpful to us.

I think we are going to see more of this type of thing. I think this is probably due in part to these types of hearings you are conducting. In summary, these developments are going to inure to our common good and that is to the public good by broadening public participation in these areas.

Senator WILLIAMS. You made my concluding speech. I appreciate that. One other thought occurred to me. We have had this available to Governors and leaders and other persons. Maybe we should make our forum available to new public members of the New York Stock Exchange.

Maybe we will find a good subject and give them an opportunity here as you have had so many times.

Mr. CALVIN. If you do that, I am sure you will be as impressed with their competence as we have been.

Senator WILLIAMS. Well, two or three have been here before other committees of the Congress, and I will agree that you have some magnificent, broad gage new members. They have been very helpful.

Dr. Juanita Kreps, for example. Well, that has been a good ending. We appreciate it so much.

(Whereupon, at 3:55 p.m., the subcommittee adjourned subject to call of the Chair.)

APPENDIX TO PROCEEDINGS CONDUCTED ON AUGUST 9

Responses to Supplementary Questions in Connection With Case Study of the Decisions Involved in Permitting Member Organizations to Sell Life Insurance

MIDWEST STOCK EXCHANGE

UNITED STATES SENATE,
COMMITTEE ON BANKING AND URBAN AFFAIRS,
Washington, D.C., August 11, 1972.

Mr. MICHAEL E. TOBIN,
*President, Midwest Stock Exchange,
120 So. LaSalle Street, Chicago, Ill.*

DEAR MR. TOBIN: The Senate Subcommittee on Securities appreciates your appearing at the August 9, 1972 hearing on the functioning of the regulatory process in the securities industry. Your cooperation and contribution in connection with the case study relating to insurance sales by exchange members will be most helpful to the Subcommittee in preparing the final report of its Securities Industry Study.

In order that the Subcommittee may have the benefit of your views on those issues raised by the insurance case which we were unable to cover at the hearings, I would appreciate your written responses to the attached questions. I hope you will also feel free to elaborate on or react to any of the remarks made at the hearing. We look forward to receiving your comments at your earliest convenience.

Sincerely,

HARRISON A. WILLIAMS, JR.

QUESTIONS FOR THE MIDWEST STOCK EXCHANGE

The following questions should be answered in the context of decision making process illustrated by the full case study the "questions and issues" included in that study may be helpful in focusing your answers.

1. What limitations does the MSE place on the ability of its member organizations and the employees of those organizations to engage in activities which are *not* kindred to the securities business?

What are the justifications for such limitations?

Is it relevant to your reasons for imposing such limitations or to your authority for doing so that the Commission has filed the following statement with the Subcommittee in response to question 7 of the institutional membership questionnaire:

The Commission indicated in its February 2, 1972 Policy Statement that it believes that the "primary purpose" requirement (for example, as it presently exists in Rule 318 of the New York Stock Exchange) is not essential to accomplish the Commission's specific objectives of ensuring the public nature of stock exchanges. Similarly, we do not believe it is crucial to these objectives to limit the types of business in which member firms may engage, for example, to those "kindred" to the securities business. Involvement in other business activities does not threaten the essential nature of the exchange markets, as public institutions. However, if an exchange should determine that a limitation of business activities to those "kindred" to the securities business is warranted in order to accomplish some other valid, self-regulatory purpose, we are not inclined to object.

2. What standards does the MSE use to determine which activities member organizations are permitted and prohibited from engaging in?

3. What authority does the Exchange have for regulating the insurance activities of its members?

4. In 1961 Mr. Keith Funston remarked: "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."

Do you agree with this statement insofar as the MSE and its members are concerned?

What standards define the scope and nature of an exchange's responsibility for the non-securities activities of its members?

5. Should the Commission expressly define the scope of self-regulatory responsibility or should the matter be left to the individual exchanges? Is there a need for legislative clarification?

6. What procedures should the exchanges follow in making significant policy determinations?

Should they be required to give notice and opportunity for public comment before making policy determinations?

Should they be required to give a public statement of the basis and purpose of their policy determinations?

Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure Act) to be followed by the exchanges in making significant policy determinations?

7. Should the Commission have followed more "formal" procedures in reviewing the rules relating to life insurance sales? What should the procedures have been?

8. Should the Commission generally utilize more "formal" procedures in reviewing significant exchange rule changes?

9. Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal? Should the Commission be required to make specific findings in "approving" rule changes? (See Sec. 6(d) of the Securities Exchange Act of 1934)

10. Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on a particular subject—e.g., arrangements whereby members will sell life insurance policies of only one company—that subject is not "questionable"?

ANSWERS FROM THE MIDWEST STOCK EXCHANGE

MIDWEST STOCK EXCHANGE,
Chicago, Ill., October 2, 1972.

SENATOR HARRISON A. WILLIAMS, Jr.,
U.S. Senate Committee on Banking, Housing and Urban Affairs, Washington,
D.C.

DEAR SENATOR WILLIAMS: We appreciate this opportunity to present our views on a number of questions relating to insurance sales by exchange members which your Subcommittee was unable to cover at the August 9, 1972 hearing.

By way of introduction, we have set forth below some pertinent provisions of our Rules which relate to the activities of member organizations and member personnel and the limitations placed on the activities of such members and personnel of member organizations.

Article I, Rule 1(c) of the Bylaws (Part II) of the Midwest Stock Exchange, Incorporated states: "The principal purpose and activity of a member firm or member corporation ("member organization") shall be . . . to conduct a general, public securities business." Following this general proscription of the principal purpose and activity of a member organization the Midwest Stock Exchange Rules describe criteria in Rules I(c) (1), (2) and (3) which are used to ascertain whether a member organization may be deemed to be engaged in the conduct of a general public securities business.

Article I, Rule 1, (0) (4) states that "a member organization meeting the foregoing qualifications as to its principal purpose and activity shall not be ineligible for membership by reason of engaging in any other aspect of the securities business (unless in violation of other rules or written policies of the Exchange), the commodities business, or to the extent permitted by Article XXXI, the life insurance business, but it may not engage in any business or businesses other than the foregoing without the express approval of the Exchange."

Article XVI, Rule 5 entitled "Employment of Registered Representatives" states that "a registered representative shall devote full time to (i) the securities business and other businesses of the member organization that are authorized by or

have been approved by the Exchange pursuant to Rule 1 (c) (4) of Article I, and (ii) the securities business of any corporate affiliate or affiliates of the member organization approved by the Exchange pursuant to Rule 7 and Rule 9 of Article XV." Rule 7 relates to the securities business of parents and subsidiaries. Rule 9 relates to interests of member organizations and member organization personnel in other corporations.

Article XXXI, Rule 3 entitled "Qualifications of Members' Employees" states "No employee of a member organization may engage in the sale of life insurance unless his qualifications are first established to the satisfaction of the Exchange by evidence of prior satisfactory experience in such work, successful completion of an approved training course or an Exchange-approved examination. Each such employee must be a full-time employee."

Our justification for the limitations recited above is premised upon our concern for the protection of the investor, the financial viability of securities firms, the potential dilution of management or supervision, and the development of professionalism on the part of member organizations and member organization personnel. Moreover, we believe that the securities business is of such financial importance and complexity that anyone engaging in it ought to be involved in it on a full-time rather than on a part-time basis. Consequently, individuals and firms that are in the securities business should not also be at the same time actively involved in other, unrelated businesses. However, this proscription is not necessarily applicable to separate entities that are affiliated in any way with member organizations. Our rules and policies provide opportunity for securities firms to be affiliated with non-securities firms provided that there is sufficient separation so that personnel, facilities and financial records of the securities firm are clearly identified.

In determining whether and how to impose limitations on the businesses engaged in by securities firms we bear in mind that the securities business includes many different specialties in addition to participating in listed markets; for example, over-the-counter markets, municipal obligations, mutual funds and corporate underwritings. These specialties have been traditionally associated with differing combinations in various firms. We do not have any difficulty in regard to permitting any activities relating to any such combination in a member organization provided that a substantial portion of the firm's business consists of acting as a broker, in listed securities or performing a recognized function on our Exchange floor.

Recently we ascertained that due to the convergence of economic and financial forces the sale of life insurance should be included as a specialized financial service by a member firm and we amended our rules so as to expressly permit this activity. See Article XXXI, Midwest Stock Exchange Constitution and Rules. This amendment reflected not so much a policy change on our part as a recognition of changes in the relationship of the securities business and the life insurance business at the customer level.

A number of developments in recent years led the Midwest Stock Exchange to conclude that the sale of life insurance can be efficiently handled by our member organizations and that the Exchange should regulate such an activity on the part of its members. It has become increasingly evident to knowledgeable investors that security investments and life insurance are integral elements in sound financial planning. The demarcation between securities investment and insurance services is not as sharp as it has been in the past. In recent years there have been many types of financial packages involving both investment and insurance components, such as mutual funds protected by insurance, equity funding, and variable annuities.

As a practical matter, the standards for determining which activities member organizations are permitted or prohibited from engaging in are not sharply defined. However, this flexibility permits securities firms to adapt their financial services to the needs of their client customers and their own operational capabilities. In terms of specific standards the Exchange raises the following type issues: are the same types of customers or clients involved; does participation in the business involve similar type training and experience; are the financial services offered interrelated; and how are the customer's financial needs best served. Obviously, there are no hard and fast lines that may be drawn which will serve at all times and places. Those lines which may be appropriate at one time may cease to be at a later time.

As a corporate matter, the scope of the Exchange's authority is set forth in its Articles of Incorporation (or prior to the recent incorporation, in its Ar-

ticles of Association). As a statutory matter, although the Securities Exchange Act of 1934 does not speak in terms of self-regulation in the insurance area, Sec. 6(c) contemplates the adoption and enforcement of rules by registered exchanges in addition to those expressly required. Further, we would consider that an exchange is authorized to engage in self-regulation deemed necessary to carry out a clear statutory purpose, whether it is a general purpose such as protection of investors and the public interest or a specific purpose such as safeguarding the financial responsibility of members.

We do not believe, as a policy matter, that it is necessary or desirable to require by statute that the Securities and Exchange Commission always make an affirmative or negative decision on important rule changes. We believe that the Commission should speak in a definitive manner to provide anti-trust exemption for actions taken by the Exchange in fulfillment of its self-regulatory responsibilities. It seems unnecessarily burdensome to require specific "findings" for all rule changes. However, the Commission should attempt to speak as unambiguously as possible as to what it is requiring, approving, accepting or not passing on.

The Exchange recognizes its responsibilities to the public, to member organizations and other self-regulatory bodies and attempts to be a dynamic participant with the Commission in the regulatory process. Consequently, it has endeavored to utilize procedures in making significant policy determinations, as in other areas, which maximize administrative efficiency without impairing its ability to act timely and consistent with its self-regulatory responsibilities.

Since policy determinations directly affect member organizations and member organizations elect their governing bodies, the member organizations have, as in most other public, quasi-public and private corporate organizations delegated policy functions to the Board of Governors or the Executive Committee of the Board of Governors. Given the dynamic character of the securities business and securities regulation, it seems to be inconsistent with good management principles and incompatible with logical and rational decision-making processes to survey our member organizations prior to every significant policy determination or to submit such policy determinations to our member organizations for ratification. Hence, it is not our practice to do so except in rather extraordinary circumstances. Policy determinations by the Exchange can also affect others than members—including other broker-dealers, professional investors, public investors and the general public. Since the Securities and Exchange Commission's oversight applies to most aspects of an Exchange's business, including significant policy determinations, the Commission itself must consider (and in recent years has considered) whether others should be given the opportunity for public comment before making significant policy determinations. We believe that it is sufficient for the purpose to leave this determination to the Securities and Exchange Commission rather than having the questions of notice and opportunity for hearing occur at two levels, first with the Exchange and secondly with the Securities and Exchange Commission.

Since the Exchange is subject to both regulation and oversight by the Securities and Exchange Commission and since all rule changes are submitted to the Securities and Exchange Commission prior to implementation it does not appear that any administrative efficiencies would be gained nor the decisionmaking process improved through amending the Securities Exchange Act of 1934 to provide certain procedural formalities as prescribed by the Administrative Procedure Act, 5 U.S.C., Paragraphs 551-559. Since Commission oversight applies to most aspects of an Exchange's business, we believe that it is sufficient to leave this to the Securities and Exchange Commission. In summary, we believe that it is unnecessary at this time to modify the Securities Exchange Act of 1934 to prescribe procedural formalities to be followed by Exchanges in making significant policy changes.

Finally, we note that in recent years the Securities and Exchange Commission has exercised its review powers much more actively than formerly. Besides adopting Rule 17a-8 to require advance filings it has adopted various procedures to both obtain and disseminate additional information from interested parties. Until there have been further experiences with these administrative practices, we believe that the present flexibility of administrative practices should be maintained so that different procedures may be used as dictated by circumstances. As a general matter, we believe it is helpful to us, and we assume it is also helpful to others, to have the Securities and Exchange Commission articulate the policies wherever possible. This procedure serves both to assure that the Commission is

acting within the scope of their powers and to provide guidance for our own activities which are subject to their oversight and regulation. As a practical matter, the scope of regulatory authority and responsibility are constantly evolving parameters which must be responsive to constantly changing circumstances. Therefore, it seems that the precise limits of regulatory authority and responsibility may be difficult to specify at particular points in time.

If we can be of any further assistance to your Subcommittee, please let me know.

Very truly yours,

MICHAEL E. TOBIN, *President.*

NEW YORK STOCK EXCHANGE

UNITED STATES SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C., August 11, 1972.

Mr. LEE D. ARNING,
*Senior Vice President, New York Stock Exchange,
11 Wall Street, New York, N.Y.*

DEAR MR. ARNING: The Senate Subcommittee on Securities appreciates your appearing at the August 9, 1972 hearing on the functioning of the regulatory process in the securities industry. Your cooperation and contribution in connection with the case study relating to insurance sales by exchange members will be most helpful to the Subcommittee in preparing the final report of its Securities Industry Study.

In order that the Subcommittee may have the benefit of your views on those issues raised by the insurance case which we were unable to cover at the hearings, I would appreciate your written responses to the attached questions. I hope you will also feel free to elaborate on or react to any of the remarks made at the hearing. We look forward to receiving your comments at your earliest convenience.

With every good wish, I am
Sincerely,

HARRISON A. WILLIAMS, Jr.

QUESTIONS FOR THE NEW YORK STOCK EXCHANGE

The following questions should be answered in the context of the decision making process illustrated by the full case study. The "questions and issues" included in that study may be helpful in focusing your answers.

1. Does the NYSE place any limitations on the ability of its member organizations and the employees of those organizations to engage in activities which are not kindred to the securities business?

If so, what is the justification for each limitation?

If not, what is the justification for restricting "kindred" activities but not similarly restricting "non-kindred" activities?

2. What standards does the NYSE use to determine which activities member organizations should be permitted and prohibited from engaging in?

3. In 1961 Mr. Keith Funston remarked: "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."

Is this still the position of the NYSE?

What standards define the scope and nature of an exchange's responsibility for the non-securities activities of its members?

4. Should the Commission expressly define the scope of self-regulatory responsibility or should the matter be left to the individual exchanges? Is there a need for legislative clarification?

5. What procedures should the exchanges follow in making significant policy determinations?

Should they be required to give notice and opportunity for public comment before making policy determinations?

Should they be required to give a public statement of the basis and purpose of their policy determinations?

Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure

Act) to be followed by the exchanges in making significant policy determinations?

6. Should the Commission have followed more "formal" procedures in reviewing the rules relating to life insurance sales? What should the procedures have been?

7. Should the Commission generally utilize more "formal" procedures in reviewing significant exchange rule changes?

8. Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal? Should the Commission be required to make specific findings in "approving" rule changes? (See Sec. 6(d) of the Securities Exchange Act of 1934).

9. Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on a particular subject—e.g., arrangements whereby members will sell insurance policies of only one company—that subject is not "questionable"?

ANSWERS FROM THE NEW YORK STOCK EXCHANGE

NEW YORK STOCK EXCHANGE, INC.,
New York, N.Y., September 12, 1972.

HON. HARRISON A. WILLIAMS, JR.,
U.S. Senate, Committee on Banking, Housing and Urban Affairs, Washington,
D.C.

DEAR SENATOR WILLIAMS: It is a pleasure to respond to your letter of August 11 to Mr. Lee D. Arning, who has left the Exchange staff.

Our answers to your questions are attached. Please let us know if we can be helpful in further explanation on these matters.

Sincerely yours,

ROBERT M. BISHOP.

ANSWERS OF ROBERT M. BISHOP TO SUPPLEMENTARY QUESTIONS OF THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS—SUBCOMMITTEE ON SECURITIES

1. Does the NYSE place any limitations on the ability of its member organizations and the employees of those organizations to engage in activities which are *not* kindred to the securities business?

If so, what is the justification for each limitation?

If not, what is the justification for restricting "kindred" activities but not similarly restricting "non-kindred" activities?

The Exchange's basic purpose is and always has been related to its members' activities as securities brokers and dealers. Section 2 of Article I of the Exchange Constitution is the formal enunciation of the Exchange's basic objects and purposes and is written in the context of its members' activities as brokers and dealers in securities. The obligations imposed upon exchanges by the Securities Exchange Act of 1934 relate also to these activities of its members and not to activities in some other area *per se*. Rule 318 as well as the Constitution specifically requires that the primary purpose of every member organization shall be the transaction of business as brokers and dealers in securities. However, in recognition of the natural desire on the part of member organizations to expand services into kindred activities, Rule 318 permits such activities, but only with the prior approval of the Exchange. This seems entirely justified, for if the Exchange's basic purpose is to upgrade the securities industry, it follows that its members' activities should be primarily devoted to this activity. Also, if the Exchange is to be in a position to effectively police its member organizations, it must be fully aware of the various activities of those member organizations and consequently must be kept informed as to what those activities are. Kindred activities of member organizations, while permissible with the prior consent of the Exchange, should be scrutinized to be sure they will not unduly expose the member organization's financial responsibility or endanger its customers or perhaps create unacceptable potential conflicts of interest.

The Exchange places an overall limit on the activities of its member organizations outside the securities business under Rule 318, which requires that at least 50% of the gross income of each member organization must be from activities as a broker or dealer in securities. Within this overall limit, the Exchange, in general, would not object to its member organizations and their employees

being investors in activities which are not kindred to the securities business, with the exception of the unlikely possibility that such an investment would associate the firm or individual with organized crime.

As a matter of practice, the Exchange also limits the active participation by members, allied members, officers and registered representatives in any activity which is not kindred to the securities business, and which is carried on outside their member organizations. Enclosed are copies of Rules 318 and 346, which establish certain guidelines for such activities. The justification for limitations which might be placed on such activities are regulatory in nature. Employees and partners of member organizations are in a general sense agents of the organization, and the Exchange is concerned lest any seemingly outside activity of such an employee or partner should create a liability for the member organization. Further, to aid in supervision and control, Exchange rules require that all partners, officers, and registered representatives should be full-time employees.

Similarly, the Exchange would scrutinize carefully any kindred or non-kindred activity in which a member organization itself engages, either within its own legal entity or in a subsidiary which is operated by the member organizations' personnel. The regulatory purpose is similar, as illustrated by the following two examples:

(a) Exchange control today is exercised principally through control of the organization's partners, officers and directors. An important point in this control is that officers and a majority of directors must be experienced in the securities business and spend the major part of their time in it. This is obviously not feasible in enterprises which are primarily in other businesses and only to a minor extent in the securities business. Consequently, the Exchange requires that member organizations be principally in the securities business. This insures the firm's officers remaining responsive to regulatory control by the Exchange.

(b) In considering the engagement of member organizations either in kindred or non-kindred businesses, the effect on regulation of the member organization's capital is also considered. Is it a business with real or contingent liabilities or assets of a type which would be difficult to evaluate for the purpose of integrating them into the Exchange's liquid capital requirement? Would the risks involved in the other activity endanger the securities customers of the member organization? It has been possible for the Exchange staff to apply reasonable capital treatment to occasional kindred or non-kindred enterprises of member organizations which do not have complicated financial structures or problems, but it is not believed that this could be done on a large scale with complicated evaluation problems in diverse industries.

In practice, this has not been a problem as it has been very rare for member organizations to desire to participate in non-kindred activities. Occasionally, in connection with its corporate finance and underwriting functions, a member organization will furnish management during the reorganization phase of the non-kindred business, usually through placing certain of the member organization personnel on leave to serve as executives of the company being reorganized.

2. What standards does the NYSE use to determine which activities member organizations should be permitted and prohibited from engaging in?

As explained above, the standards applied are primarily whether the type of activity would create risk for securities customers, whether the assets and liabilities associated with the proposed activity can be reasonably comprehended within broker-dealer capital regulation, whether the activity would unduly distract firm management from their primary responsibilities as broker-dealers.

3. In 1961 Keith Funston remarked: "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."

Is this still the position of the NYSE?

What standards define the scope and nature of an exchange's responsibility for the non-securities activities of its members?

It is still the position of the Exchange that any member is responsible to the Exchange for *any* business conduct, but it is not the position of the Exchange that the Exchange has, in practice, equal responsibility for surveillance of each line of endeavor of a member. The surveillance responsibilities of the Exchange are primarily in the areas of the NYSE marketplace and financial responsibility of its members and member organizations. The Exchange's principal surveillance and regulatory efforts are directed to these responsibilities. Competent regulation of certain other areas of the securities business is primarily provided by other national securities exchanges, the National Association of Securities Dealers, or

the SEC. Similarly, the Exchange believes that where competent regulation of other permissible member organization activities is provided by governmental agencies, such as appears to be the case with the sale of life insurance, this regulation can best be left to the expertise of those agencies, at least until evidence to the contrary is developed.

4. Should the Commission expressly define the scope of self-regulatory responsibility or should the matter be left to the individual exchanges? Is there a need for legislative clarification?

It may be desirable for the SEC to define the scope of self-regulatory responsibility of individual organizations.

5. What procedures should the exchanges follow in making significant policy determinations?

Should they be required to give notice and opportunity for public comment before making policy determinations?

Should they be required to give a public statement of the basis and purpose of their policy determinations?

Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure Act) to be followed by the exchanges in making significant policy determinations?

Exchange president, Robert W. Haack, on November 17, 1971 in testimony before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce responded to a question regarding the manner in which the adoption of rules of national securities exchanges could be made more public. In this connection, the House Committee referred to suggestions made in a recent note in the 80 Yale Law Journal 811 (1971) which suggested that, in effect, all proposed rules of national securities exchanges be publicized by the SEC, that important rules be subject to SEC public hearings or that the Commission solicit comments on proposed exchange rules; and, that "the SEC should write an opinion articulating its findings and reasons in connection with any exchange reforms it approves."

In response to the question, the Exchange indicated that it would support such a procedure and would welcome it. "Our only concern would be that any new procedure not delay necessary action by the Exchange or hamper the Exchange from acting expeditiously when circumstances require prompt, decisive action."

6. Should the Commission have followed more "formal" procedures in reviewing the rules relating to life insurance sales? What should the procedures have been?

As we understand the testimony at the hearing on September 9, 1971, the Commission believes that it is prohibited by law from regulating the activities of broker-dealers in the area of life insurance sales. In view of this, we do not believe the more formal procedures would have been in order in reviewing the rules relating to life insurance sales.

7. Should the Commission generally utilize more "formal" procedures in reviewing significant exchange rule changes?

The Exchange supports the more formal procedures suggested in our answer to Question 5.

2. Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal? Should the Commission be required to make specific findings in "approving" rule changes? (See Section 6(d) of the Securities Exchange Act of 1934)

We do not think that the Act should be amended in the insurance area. However, it might be desirable for the Commission to make "findings" on proposals, as, among other things, a means of providing policy direction to the exchanges and others.

9. Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on a particular subject—e.g., arrangements whereby members will sell insurance policies of only one company—that subject is not "questionable"?

The general answer to the above question is "no". However, it has, for example, been the practice for many years among broker-dealers to sell mutual funds of only one sponsor. To our knowledge this practice has not been challenged as an unethical practice by the SEC. Further, we have observed that it is not unusual for the policies issued by only one insurance company to be sold by its own agents or those of independent insurance brokers.

[Reprinted from the New York Stock Exchange Guide]

2318 OTHER CONNECTIONS OF MEMBERS AND ALLIED MEMBERS

Rule 318. The primary purpose of every member organization, and any parent or any member corporation, shall be the transaction of business as a broker or dealer in securities. With the prior approval of the Exchange, member organizations may engage in any activities kindred to the securities business.

No member corporation shall have as a parent any party (other than a member or allied member of such member corporation) unless, for a period of not less than two years, the primary purpose of such party has been and continues to be the transaction of business as a broker or dealer in securities, and such party is and continues to be registered with the Securities and Exchange Commission as a broker or dealer in securities under the Securities Exchange Act of 1934 and promptly files with the Exchange a copy of its registration statement under said Act and of each amendment thereto.

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 a 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. March 26, 1970.

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.

12 Definitions.—For the purposes of this Rule, a member organization's, or its parent's activities shall be considered to be the "transaction of business as a broker or dealer in securities" when such member organization including its ap-

proved corporate affiliates and subsidiaries, or its parent, as the case may be, acts as a Floor trader, specialist, so-called "two dollar broker", odd lot broker, arbitraguer or holds itself out to, and transacts business generally with the public as a broker or dealer in securities, including servicing customers' accounts and introducing them to another member organization. A member organization's, or its parent's, "primary purpose" shall be presumed to be the transaction of business as a broker or dealer in securities, if its gross income (including in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization) from activities of the type described in the preceding sentence and from interest charges imposed with respect to debit balances in customers' accounts is at least 50% of its total gross income (including, in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization). Any member organization, and any parent of a member corporation, whose gross income fails to satisfy the above requirement shall be presumed not to have as its primary purpose the transaction of business as a broker or dealer in securities. Any such presumption may be rebutted by evidence but shall continue until a determination to the contrary has been made by the Board of Governors.

The term "parent" means any party who has the power to exercise controlling influence over the management or policies of a member corporation, unless such power is solely the result of an official position with such member corporation. Any party who owns beneficially, either directly or indirectly, more than 25% of the voting securities of a member corporation, or more than 25% of the outstanding voting securities of any other corporation which directly or through one or more subsidiaries owns beneficially more than 25% of the outstanding voting securities of the member corporation, shall be presumed to be the member corporation's parent. Any party who does not so own more than 25% of the voting securities of a member corporation shall be presumed not to be such corporation's parent. Any such presumption may be rebutted by evidence but shall continue until a determination to the contrary has been made by the Board of Governors.

13 Life Insurance.—A member organization may engage in the sale of life insurance (directly, or through its corporate affiliate or subsidiary) only through one or more members, allied members and registered representatives.

2346 EMPLOYEES—FIXED DUTIES

Rule 346. Every registered representative or officer 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, or own any stock, or have, directly or indirectly, any financial interest in any other member organization or any non-member organization engaged in any securities, financial or kindred business without the prior written approval of the Exchange, or except as otherwise permitted by the Rules of the Board of Governors.

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, firms 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. (See ¶ 2350)

Amendment: March 26, 1970.

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 member, allied member or competent authorized delegate 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.

Amendment: March 26, 1970.

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 member, allied member or competent authorized delegate

(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.

Amendment: March 26, 1970.

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.

15 Director or Officer.—Consent of the Exchange will not be required for the following activities, provided the member or member organization employer wishes to have the employee so serve and the activities do not interfere with the performance of full-time duties of the registered representative:

(1) Director of up to three corporations not in the securities business, including chairman of the board of directors of one corporation if not chief executive officer.

(2) Director of a bank or trust company in compliance with state and federal banking laws.

(3) Officer of an operating company not in the securities business, if duties are nominal and non-operational.

The Exchange will consider on their individual circumstances any requests for outside activities which do not conform with the above conditions.

16 Leave of Absence.—Consent of the Exchange will not be required for leave of absence, provided all of the following conditions are met:

(1) The member or member organization employer retains a written record of the leave.

(2) The registered representative is not physically present at any office of his employer, and does not act as a registered representative of his employer.

(3) The registered representative does not use the leave to engage in any other business, or be employed by any other corporation, firm or individual, or serve as a partner, officer or director of any other partnership or corporation.

(4) The total time on leave of absence does not exceed one year.

(5) The registered representative receives no compensation from the firm other than maintenance of fringe benefits such as medical insurance, etc.

The Exchange will consider on their individual circumstances any requests for leave of absence which do not conform with the above conditions.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C., September 20, 1972.

Mr. ROBERT M. BISHOP,
*Vice President and Director, New York Stock Exchange, Inc., Department of
Member Firms, New York, N.Y.*

DEAR Mr. BISHOP: Thank you for responding to the questions in my letter of August 11, 1972. Your response does not, however, answer directly a question of major interest to the Subcommittee on Securities. I would, therefore, appreciate receiving for inclusion in the hearing record the answer to the following:

Apart from the requirement in Exchange Rule 318 that the "primary purpose" of a member organization must be the "transaction of business as a broker or dealer in securities" (as those terms are defined in Rule 318.12), does the Exchange have any rule, as defined in SEC Rule 17a-8, which (a) prohibits a member organization from engaging directly or through a subsidiary in activities not kindred to the securities business or (b) requires a member organization to obtain Exchange approval before engaging in such activities? If so, please specifically identify the rule(s) and supply the Subcommittee with all materials concerning the rule(s) which have been made available to member organizations but which are not printed in the Commerce Clearing House edition of the New York Exchange Guide.

Thank you for your attention to this request.

Sincerely,

HARRISON A. WILLIAMS, Jr.

NEW YORK STOCK EXCHANGE, INC.,
New York, N.Y., October 9, 1972.

HON. HARRISON A. WILLIAMS, Jr.,
*Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington,
D.C.*

DEAR SENATOR WILLIAMS: I appreciate the opportunity to further clarify our testimony to the Subcommittee on Securities as expanded in our letter of September 12.

Your letter of September 20 further asks whether the Exchange has any rule prohibiting a member organization or its subsidiaries from engaging in activities not kindred to the securities business or requiring member organizations to obtain Exchange approval before engaging in such activities. The Exchange

does not have such a rule. In practice this has not been a problem. As I explained in my letter of August 11, as a matter of practice, firms do consult with us before engaging in non-kindred activities. In addition, our Examining staff who now visit each firm at least once a year, cover this matter in their examination. Our Examiners' reports, made as a result of their examinations in the firm offices, routinely include a short description of the kind of business in which member organizations engage, which would reveal to us such non-kindred activities. The Examiner would determine if the firm engaged in these activities without first consulting the Exchange.

If Exchange organizations become interested in engaging in non-kindred activities on a broader basis, perhaps this matter would need to become more specifically addressed through a rule amendment, but it does not seem necessary at this time in view of present practice.

Please let us know if we can be of further help in clarifying this matter or if information has come to your attention indicating that the Exchange should have such a rule.

Sincerely yours,

ROBERT M. BISHOP.

SECURITIES AND EXCHANGE COMMISSION

UNITED STATES SENATE,

U.S. SENATE,

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,

Washington, D.C., August 11, 1972.

Hon. PHILIP A. LOOMIS, Jr.,
Commissioner, Securities and Exchange Commission,
Washington, D.C.

DEAR COMMISSIONER LOOMIS: The Senate Subcommittee on Securities appreciates your appearing at the August 9, 1972 hearing on the functioning of the regulatory process in the securities industry. Your cooperation and contribution in connection with the case study relating to insurance sales by exchange members will be most helpful to the Subcommittee in preparing the final report of its Securities Industry Study.

In order that the Subcommittee may have the benefit of your views on those issues raised by the insurance case which we were unable to cover at the hearings, I would appreciate your written responses to the attached questions. I hope you will also feel free to elaborate on or react to any of the remarks made at the hearing. We look forward to receiving your comments at your earliest convenience.

Sincerely,

HARRISON A. WILLIAMS, Jr.

QUESTIONS FOR THE SECURITIES AND EXCHANGE COMMISSION

The following questions should be answered in the context of the decision making process illustrated by the full case study. The "questions and issues" included in that study may be helpful in focusing your answers.

1. Is it necessary or appropriate for the protection of public customers or otherwise for the exchanges to place limitations on the kinds of businesses in which their member organizations may engage?

Do the exchanges have the authority to impose such limitations?

Does the Commission have the authority to oversee the exercise of that authority?

Does the Commission have the authority to limit directly the kinds of businesses in which exchange members may engage?

2. What oversight authority does the Commission have with respect to the exchanges' regulation of (a) the sale of insurance by member firms and (b) other non-securities businesses of member firms?

What is content of this authority?

Should the authority be expanded?

Do the exchanges have self-regulatory duties which are not subject to Commission oversight?

3. Should the Commission expressly define the scope of self-regulatory responsibility or should the matter be left to the individual exchanges? Is there a need for legislative clarification?

4. What procedures should the exchanges follow in making significant policy determinations?

Should they be required to give notice and opportunity for public comment before making policy determinations?

Should they be required to give a public statement of the basis and purpose of their policy determinations?

Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure Act) to be followed by the exchanges in making significant policy determinations?

5. What are the Commission's procedures for reviewing significant changes in the rules of the various stock exchanges?

6. Is all correspondence between the SEC and an exchange concerning a Rule 17a-8 filing made a matter of public record at the time it is sent or received?

7. Should the Commission have followed more "formal" procedures in reviewing the rules relating to life insurance sales? What should the procedures have been?

8. Should the Commission generally utilize more "formal" procedures in reviewing significant exchange rule changes?

9. Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal? Should the Commission be required to make specific findings in "approving" rule changes? (See Sec. 6(d) of the Securities Exchange Act of 1934)

10. Without a written Commission opinion articulating its findings and reasons in passing on exchange rule changes of the importance of the NYSE's insurance proposals, what techniques are available to the Congress to evaluate the adequacy of the Commission's review and oversight procedures?

11. Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on a particular subject—e.g., arrangements whereby members will sell insurance policies of only one company—that subject is not "questionable"?

ANSWERS FROM THE SECURITIES AND EXCHANGE COMMISSION

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., October 20, 1972.

HON. HARRISON A. WILLIAMS, JR.,
Chairman, Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR SENATOR WILLIAMS: In connection with your Subcommittee's inquiry into the self-regulatory process embodied in the Securities Exchange Act of 1934, you have been studying, among other things, the processes involved in the decisions made concerning the sale of life insurance by member firms of certain of the registered national securities exchanges. I had the pleasure of testifying before your Subcommittee on this topic last August. In order to facilitate your study, you have requested that I respond to certain supplementary questions you have posed on this topic.

Pursuant to your request, I have annexed to this letter my responses to the questions you have raised. Since the questions posed raise broad and important questions, albeit in the context of a somewhat atypical self-regulatory decision, my responses are fairly lengthy, even though I have attempted, for the convenience of the Subcommittee and its staff, to keep them as brief as I could.

I trust that the attached responses to your questions will be of assistance to you in completing your study of the complex and important subject of self-regulation. I stand ready to assist you further in this endeavor if you believe that I may be able to make any additional contribution. Please call upon me if you think I can provide any help.

Sincerely,

PHILIP A. LOOMIS, JR., *Commissioner.*

RESPONSE OF PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, TO QUESTIONS, CONCERNING THE SALE OF LIFE INSURANCE BY MEMBER FIRMS OF CERTAIN REGISTERED NATIONAL SECURITIES EXCHANGE

1. Is it necessary or appropriate for the protection of public customers or otherwise for the exchanges to place limitations on the kinds of businesses in which their member organizations may engage?

(a) Do the exchanges have the authority to impose such limitations?

(b) Does the Commission have the authority to oversee the exercise of that authority?

(c) Does the Commission have the authority to limit directly the kinds of businesses in which exchange members may engage?

It may well be necessary or appropriate, depending upon the then prevailing circumstances and the nature of the "extracurricular" activity involved, for exchanges to limit the kinds of businesses in which their member organizations may engage or the methods by which their members may engage in such businesses.

Under the Securities Exchange Act, all registered exchanges are charged with upholding the "public interest in the same degree as any other great utility."¹ And, in adopting the bill that ultimately became the Securities Exchange Act, Congress noted that "the effect of the bill will be to give to the well-managed exchanges that power necessary to enable them to effect themselves needed reforms. . . ."² Of course, the "public interest" concept contained in the Securities Exchange Act must be viewed in the context of the Act and its purposes.³ And, in seeking to pinpoint the authority of exchanges to promulgate rules governing the conduct of the members of exchanges as well as their employees, reference should also be made to Section 6(c) of the Securities Exchange Act, 15 U.S.C. 78f(c), which negatives the notion that the Securities Exchange Act is exclusive with respect to the authority of exchanges to promulgate rules.⁴

In light of these rather broad responsibilities and statutory obligations, registered exchanges have, for many years, found it necessary or appropriate⁵ to place reasonable restrictions on the business activities of members and their employees. Thus, registered exchanges have found it necessary to require that the primary purpose of member firms shall be the securities business, together with kindred activities, if approved by the exchange, and registered employees are required to devote full time to the business of their firms, except as the exchange may otherwise authorize.⁶ Similarly, exchanges reasonably could conclude their members should not engage in other businesses which might (1) involve an undue risk of capital losses, (2) create conflicts of interest or (3) detract from investor

¹ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934). See also, Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

² H.R. Rep. No. 1383, *supra* n. 1, at p. 15.

³ See, e.g., *Alabama Electric Cooperative, Inc. v. Securities and Exchange Commission*, 353 F. 2d 905, 907 (C.A. D.C., 1965), *certiorari denied*, 383 U.S. 968 (1966), where the court observed:

"Words like 'public interest' . . . , though of wide generality, take their meaning and definition from the substantive provisions and purposes of the Act."

⁴ Section 6(c) provides:

"Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located."

⁵ The phrase "necessary or appropriate" contained in the Subcommittee's question is a phrase used repeatedly throughout the Securities Exchange Act in delegating responsibility. See, e.g., Sections 5, 9, 10, 11, 12, 13, 14, 15, 16 and 19, 15 U.S.C. 78e, 78i, 78j, 78k, 78l, 78m, 78n, 78o, 78p and 78s. While the term "necessary" embodies a well-defined concept of certainty, I believe the term "appropriate" embodies the notion of discretion and flexibility, in accordance with broad, general principles.

⁶ See, e.g., New York Stock Exchange Rule 318, 2 CCH *New York Stock Exchange Guide*, ¶2318, at 3075; New York Stock Exchange Rule 346, 2 CCH *New York Stock Exchange Guide*, ¶2346, at 3597-3.

See also, American Stock Exchange Rule 342, 2 CCH *American Stock Exchange Guide* ¶9392, at 2625-3; Midwest Stock Exchange Rules, Article XVI, Rule 5; CCH *Midwest Stock Exchange Guide* ¶2332. The Midwest Stock Exchange does, of course, permit the sale of life insurance by its members, see Article I, Rule 1(c)(4) of its Rules, CCH *Midwest Stock Exchange Guide* ¶2021, at 2022, but its rules explicitly adopt the view of the other exchanges that its members' employees otherwise should devote their full time to securities business (including commodities business).

confidence in a particular firm or the exchange community⁷—for example, an exchange could determine that its members may not sell lottery tickets, even in a state where such sales are legal, or could determine that its members should not sell used cars. Because the standard of “appropriateness” is necessarily a broad one, dependent upon the confluence of many circumstances, it is not determinative of the issue posed that different exchanges may reach differing conclusions regarding limitations on the kinds of businesses in which member organizations may engage.

As I have indicated, I believe the exchanges do have the authority to impose these kinds of limitations upon their members, as long as the exchanges reasonably may conclude that the limitation involved, in the light of all prevailing conditions and circumstances; is necessary or appropriate for the protection of investors or other broad public purposes with which the exchange reasonably may be concerned; and the Commission may, under the Securities Exchange Act, oversee the exchanges’ general exercise of that authority. As I have pointed out during my testimony before this Subcommittee on August 9, 1972, however, I believe that the Commission’s authority (as opposed to that of the exchanges) to oversee the exchanges in the area of selling life insurance may be limited by the provisions of the McCarran-Ferguson Act.⁸

The question of the Commission’s direct authority to limit the entry of exchange member firms into a particular business is, to a large extent, linked to the Commission’s oversight responsibilities. It was intended by the Congress that adopted the Securities Exchange Act that the Commission’s authority over exchanges should be residual in nature.⁹ Nevertheless, direct authority over the practices of exchanges was vested in the Commission,¹⁰ and the Commission has been inclined to construe this authority broadly.¹¹ I believe that the answer to the question whether the Commission could directly limit the entry of a member firm into a particular business can depend upon such factors as

⁷ This is not to say, of course, that restrictions on the businesses engaged in by the so-called parent of any member firm are appropriate or necessary. As the Commission noted in its recent policy statement,

“... where an institution establishes or acquires a broker-dealer doing business for the general public—we perceive no reason either of law or policy why this should not be permitted. . . . This necessarily implies elimination of the so-called ‘parent test.’”

Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* at pp. 21–22 (G.P.O. ed., Feb. 2, 1972).

⁸ See Section 2(b) of the McCarran-Ferguson Act, 15 U.S.C. 1012(b), which provides, in pertinent part:

“No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance. . . .”

The impact of the McCarran-Ferguson Act on the Securities Exchange Act and this Commission’s statutory authority was considered by the Supreme Court in *Securities and Exchange Commission v. National Securities, Inc.*, 393 U.S. 453 (1969), a case involving the allegedly fraudulent solicitation of proxies from the shareholders of an insurance company to bring about the approval of a merger which also required the approval of the State Insurance Commissioner. The Court held that, in general, the relationship between a stock life insurance company and its shareholders does not constitute “the business of insurance” within the meaning of the McCarran-Ferguson Act, and that, as a consequence, the proxy and antifraud provisions of the Securities Exchange Act were not superseded with respect to insurance companies. The Court, however, did hold (393 U.S. at 460), relying on its prior decisions in *Federal Trade Commission v. National Casualty Co.*, 357 U.S. 560 (1958), and *Robertson v. California*, 328 U.S. 440 (1946), that the advertisement and sale of insurance policies and the licensing of insurance agents and salesmen constituted “the business of insurance” within the meaning of the McCarran-Ferguson Act. Under these circumstances, it could be argued that the Securities Exchange Act, if otherwise applicable to these precise activities, was superseded by Section 2(b) of the McCarran-Ferguson Act.

Of course, the sale of anything less than a policy issued by an insurance company might well subject the activity to the Commission’s jurisdiction if what is being sold is a security, as that term is defined in Section 2(1) of the Securities Act, 15 U.S.C. 77b(1). See *Securities and Exchange Commission v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *Securities and Exchange Commission v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 67–69 (1959).

⁹ See, e.g., H.R. Rep. No. 1383, *supra*, n. 1, at p. 15 (emphasis supplied): “Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped . . . that the occasion for direct action by the Commission will not arise.”

¹⁰ See generally Sections 2, 6, 11, 17, 19 and 23 of the Securities Exchange Act.

¹¹ See, e.g., Securities and Exchange Commission, *Report on the Government of Securities Exchanges*, H.R. Doc. No. 85, 74th Cong., 1st Sess. 6 (1935); Securities and Exchange Commission, *Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 40 (House Comm. Print 1941); *In the Matter of the Rules of the New York Stock Exchange*, 10 S.E.C. 270 (1941); cf. *Stark v. New York Stock Exchange, Inc.*, CCH Fed. Sec. L. Rep. ¶93,573 (S.D. N.Y., July 20, 1972), affirmed *per curiam*, CCH Fed. Sec. L. Rep. ¶93,607 (C.A. 2, Aug. 29, 1972).

the nature of that business and the impact of such entry upon the firm's ability to meet the standards established by the Securities Exchange Act.¹²

2. *What oversight authority does the Commission have with respect to the exchanges' regulation of (a) the sale of insurance by member firms and (b) other non-securities businesses of member firms?*

(a) *What is the content of this authority?*

(b) *Should the authority be expanded?*

(c) *Do the exchanges have self-regulatory duties which are not subject to Commission oversight?*

My response to the preceding question expresses my views with respect to Questions 2(a) and 2(c). The Commission's exercise of direct oversight authority over participation in non-securities businesses by member firms requires a balancing of the goals of self-regulation with the need for direct government action and a balancing, in the case of insurance, between the McCarran-Ferguson Act proscriptions on the federal government's exercise of authority with the aims and intent of the Securities Exchange Act.

The Commission has proposed that Congress increase, in certain specified respects, the Commission's direct oversight of exchange activities, and these proposals appear in H.R. 15303. Thus, among other things, the proposed legislation would strengthen the Commission's authority with respect to the adoption, alteration and rescission of the rules of exchanges and would increase the Commission's authority to enforce such rules against members of, and persons associated with members of, self-regulatory organizations. Aside from this proposal, and in the absence of experience to be gained from the effectuation of a central market system,¹³ I do not believe it is possible to offer further pertinent and useful suggestions concerning the Commission's oversight authority at this time. I should add, of course, that I have not been aware of any compelling reason upon which to predicate a recommendation that the impact of the McCarran-Ferguson Act be diluted or altered in any way. The Congressional aims underlying that Act are, of course, matters beyond my expertise; but I am unaware of any serious difficulties encountered by the Commission in the implementation of its mandate under the federal securities laws that have resulted from the applicability of the McCarran-Ferguson Act.¹⁴

3. *Should the Commission expressly define the scope of self-regulatory responsibility or should the matter be left to the individual exchanges? Is there a need for legislative clarification?*

The scope of self-regulatory responsibility already is defined—by the Securities Exchange Act and that Act's legislative history.¹⁵ While the Commission has, of course, asked for a measure of broader authority concerning its oversight of certain of the activities of self-regulatory agencies,¹⁶ I do not believe this should be construed as an indication that the Commission believes the scope of self-regulatory responsibility should be redefined by the Commission. And, I see no reason at this time, for either the Commission, the self-regulatory agencies or the Congress to attempt to redefine the entire scope of self-regulatory responsibilities.

The organization of the markets is now undergoing considerable reevaluation in light of the Commission's position that, in order to improve the manner in which the securities markets serve the public, the future structure of the securities markets requires the evolution of a centralized market system, with open access by all qualified brokers and market makers.¹⁷ When the parameters and

¹² Thus, for example, consider Section 19(b)(1) of the Securities Exchange Act, 15 U.S.C. 78s(b)(1), giving the Commission direct authority to alter or supplement the rules of national stock exchanges concerning "safeguards in respect of the financial responsibility of members," and Section 19(b)(5), 15 U.S.C. 78s(b)(5), giving the Commission direct authority concerning "the manner, method, and place of soliciting business." See also, Section 19(b)(13), 15 U.S.C. 78s(b)(13), covering other "similar matters."

¹³ See the discussion at pp. 10-11, *infra*.

¹⁴ The Commission has, in its various enforcement efforts involving the activities of insurance companies believed to be encompassed by the federal securities laws, met with judicial approval.

¹⁵ See, e.g., Sections 2, 6, 11, 17 and 19 of the Securities Exchange Act: See generally, *Report to Secretary of Commerce of Comm. on Stock Exchange Regulation*, 73d Cong., 2d Sess. (Sen. Comm. Print, 1934); and S. Rep. No. 792, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 1383, *supra*, n. 1.

¹⁶ The Commission's proposals are embodied in H.R. 15303, 92d Cong., 2d Sess. (1972).

¹⁷ This position was first expressed by the Commission in its letter transmitting the *Institutional Investor Study Report* to Congress and subsequently was expressed in the Commission's policy statement on the future structure of the securities industry, issued in February of this year. See Securities and Exchange Commission, *Institutional Investor*

scope of the central market system are more sharply in focus, I believe that it may be appropriate to reconsider whether any change in the definition of the scope of self-regulatory responsibility should be effected and, if so, what body or bodies should effect such a change.

4. *What procedures should the exchanges follow in making significant policy determinations?*

(a) *Should they be required to give notice and opportunity for public comment before making policy determinations?*

(b) *Should they be required to give a public statement of the basis and purpose of their policy determinations?*

(c) *Should the Securities Exchange Act of 1934 be amended to prescribe minimum procedural formalities (e.g., similar to those in the Administrative Procedure Act) to be followed by the exchanges in making significant policy determinations?*

It is my opinion that the self-regulatory bodies should be required to afford an opportunity for general public comment on all proposed rules and policy determinations have any significant impact, either upon their membership as a whole, or, particularly, upon nonmembers. Similarly, I believe it would be consistent with this approach if the exchanges were to publish a statement of the basis and purpose of their *major* policy determinations. I would not, of course, extend these views to housekeeping or limited-impact policy determinations or rules.¹⁸

I understand that the self-regulatory bodies already are initiating valuable efforts to implement this objective. Thus, for example, the major exchanges are significantly expanding public participation in their governing boards. And, just recently, the American Stock Exchange submitted to the Commission a proposal to accord exchange members and other interested persons an opportunity to comment upon major rule and policy proposals before their final adoption by the Exchange's Board of Governors.¹⁹ I am confident that, as experience with these new procedures is obtained, further improvements will follow. Naturally, the benefit of these procedures is dependent upon the way they are in fact implemented. But I am in accord with the philosophy embodied by these new policies.

Similar developments have occurred with respect to self-regulatory disciplinary proceedings. Thus, in the last several months, both the New York and American Exchanges have submitted proposals to revise their proceedings.²⁰

These steps represent initial efforts to alleviate some of the criticism that has been directed toward exchange disciplinary proceedings.²¹ This is one area where the Commission has recommended that it be given greater powers of governmental oversight than presently exist.

The Commission also is considering the recommendations of its Advisory Committee on Enforcement Policies and Practices concerning increased publicity for self-regulatory disciplinary proceedings.²²

Study Report, H.R. Doc. No. 92-64, 92d Cong., 1st Sess., pt. 1 (1971), pp. xxlii-xxv; Securities and Exchange Commission, *Statement on the Future Structure of the Securities Market* at p. 7 (G.P.O. Ed., Feb. 2, 1972). Cf. Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, *Report of Securities Industry Study*, H.R. Rep. No. 92-1519, 92d Cong., 2d Sess. 117-130 (1972); Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, *Report of the Securities Industry Study*, 92d Cong., 2d Sess. 45-46 (Comm. Print, 1972).

¹⁸ As you are aware, the exchanges not only have self-regulatory responsibilities, but also are business organizations engaged in conducting day-to-day business operations of substantial magnitude and involving substantial expense, in connection with operating a major market. Rules and policy determinations relating to the latter aspect of exchange operations may not be appropriate for public comment.

¹⁹ Depending upon the nature of the issue involved, the American Stock Exchange has indicated that it may solicit written comments or entertain oral presentations. A copy of the AMEX's letter submitting this proposal to the Commission was annexed to the statement I submitted to this Subcommittee on Oct. 5, 1972.

²⁰ The proposals of the New York Stock Exchange would provide, among other things, right to counsel and an opportunity for a hearing before a panel composed of a chairman (a member of the exchange staff) and at least two exchange members in the case of an action involving a member, or at least two registered persons or employees in the case of actions against registered representatives or employees. The Board of Governors will act as a review body and review will occur at the request of the staff of the exchange, the respondent or at least a single governor. Continuing the present practice of the exchange, written transcripts of each proceeding will be prepared and the Commission has requested that a digest of each proceeding be furnished to each governor so that the review power may be effectively and expeditiously exercised. The American Stock Exchange has adopted comparable substantive provisions with some variations.

²¹ See, e.g., *Intercontinental Indus., Inc. v. American Stock Exchange*, 452 F. 2d 935 (C.A. 5, 1971), *certiorari denied*, 41 U.S.L.W. 3184 (U.S., Oct. 10, 1972) (No. 71-1378).

²² See *Report of the Commission's Advisory Committee on Enforcement Policies and Practices*, BNA Securities Regulation & Law Report No. 158 (June 28, 1972), at pp. 2 and 16.

I do not believe that the self-regulatory bodies should be saddled with the whole panoply of government administrative procedure of the type imposed upon agencies of the federal government under the Administrative Procedure Act. I doubt if it would be suitable for nongovernmental organizations, and furthermore, based on my experience as a government official for many years and as a member of the Administrative Conference of the United States, I have concluded that the imposition of government administrative procedure is not without serious problems, including delay, cumbersome formalities, and unnecessary expense for all concerned.

5. *What are the Commission's procedures for reviewing significant changes in the rules of the various stock exchanges?*

6. *Is all correspondence between the SEC and an exchange concerning a Rule 17a-8 filing made a matter of public record at the time it is sent or received?*

The Commission's procedures for reviewing changes in the rules of the various stock exchanges have varied and evolved over the years in the light of experience.

At one time, in view of the lack of any grant, in the Securities Exchange Act, of express power to the Commission to approve or disapprove proposed exchange rules,²³ and the implication which some commentators have suggested might be drawn from Section 6(a)(4) of the Securities Exchange Act, 15 U.S.C. 78f (a)(4), that the exchanges are entitled to amend their rules without prior consultation with the Commission,²⁴ there was no organized review procedure. By agreement, however, the exchanges normally gave the Commission's staff advance notice of "significant" proposals.²⁵

This voluntary arrangement by which the Commission was apprised of exchange rule proposals was later changed, particularly in response to suggestions of the *Special Study* in 1963.²⁶ Proposed exchange rules are now filed with the Commission in advance, pursuant to Securities Exchange Act Rule 17a-8, 17 CFR 240.17a-8, which was adopted to implement the *Special Study's* recommendation. Consonant with the theory of self-regulation embodied in the Securities Exchange Act and the residual authority granted to the Commission to alter or amend exchange rules, Rule 17a-8(d) provides that "the failure on the part of an exchange to file a report . . . shall not affect the validity, force or effect of any rule of the exchange. . . ."

The nature of Commission review of exchange rule proposals, of course, varies with the nature and importance of the rule. Some rule changes are inconsequential and require very little review.²⁷ In other instances, where the exact meaning or purpose of a proposed rule is not entirely clear, the Commission's staff will request clarification, both to determine exactly what the exchange has in mind, and to enable it to suggest, where appropriate, clarifying changes in the proposed rule. Similarly, where the Commission or its staff requires further information as to technical matters, or opinions as to the potential impact of a proposed rule, this will be sought both from the exchange proposing it and, if necessary, from persons expert in the particular area involved, including, where appropriate, other exchanges which have dealt with similar problems. And, where it appears or is anticipated that a proposed exchange rule may have a significant impact on the securities markets or upon the public, the Commission currently will give public notice of the proposal and solicit comments, unless it appears that this is unnecessary by reason of adequate notice and opportunity for comment having

²³ Compare the Commission's authority with respect to national securities associations, embodied in Section 15A(j) of the Securities Exchange Act, 15 U.S.C. 78o-3(j).

Under Section 19(b) of the Act, of course, the Commission may, within certain limits, alter or amend existing exchange rules. In *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963), the Supreme Court noted that the Securities Exchange Act, in giving the Commission power "to request exchanges to make changes in their rules . . . impliedly, therefore [suggests authority] to disapprove any rules adopted by an exchange. . . ."

²⁴ Section 6(a)(4) provides (emphasis supplied):

"Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information and accompanied by the documents, below specified:

* * * * *

"(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption."

²⁵ See Securities and Exchange Commission, *Report of Special Study of the Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) at pp. 711-713 (hereafter, "*Special Study*").

²⁶ *Special Study*, supra n. 25, pt. 4 at pp. 711-713, 725-727.

²⁷ See, for example, where, following its incorporation, the New York Stock Exchange revised most of its rules to change references to that exchange's "Board of Governors" to read "Board of Directors."

been given by the exchange.²⁸ In this connection, it is to be noted that persons having comments on proposed exchange rules notice for comment by the exchanges usually provide such comments not only to the exchange, but also to the Commission.

When, following the completion of whatever procedures are found necessary, the staff has formulated a position with respect to the proposed rule, this is submitted to the Commission and discussed, after which the reaction of the Commission to the proposal and any suggested changes in it are communicated to the exchange. The Commission has adopted a policy of placing all proposed rule amendments by exchanges and the Commission's definitive responses in a public file for ready access by all interested members of the public. This policy became effective in March, 1972.²⁹

7. *Should the Commission have followed more "formal" procedures in reviewing the rules relating to life insurance sales? What should the procedures have been?*

8. *Should the Commission generally utilize more "formal" procedures in reviewing significant exchange rule changes?*

The current Commission procedures for reviewing exchange rule changes are described in my response to Question 5.³⁰ At the hearings held before this Subcommittee on October 5, 1972, representatives of the New York Stock Exchange, the American Stock Exchange and the National Association of Securities Dealers, Inc., recognized the desirability of procedures for affording public notice and opportunity for comment in connection with significant exchange rule proposals, and I concurred in this view. Exact procedures for accomplishing this will need to be more fully developed. Aside from this, I see no need for greater formality in the review of exchange rule procedures. When notice and comment procedures are more fully developed, the procedures for exchange rule making will be comparable to the formality now required for rule making by federal administrative agencies under the Administrative Procedure Act. I do not believe that greater formality is necessary in the exchange rule making area.

In this connection, I refer the Subcommittee to my statement before this Subcommittee on August 8, 1972, in which I expressed the view that considerable informality in Commission oversight of the self-regulatory bodies was appropriate since the Commission and these bodies are engaged in "cooperative" regulation in the public interest, and the relationships between them should not be modeled on an adversary proceeding in court. I adhere to that view.

9. *Should the Exchange Act be amended to require the Commission to make an affirmative or negative decision on exchange rule changes of the importance of the insurance proposal? Should the Commission be required to make specific findings in "approving" rule changes? (See Sec. 6(d) of the Securities Exchange Act of 1934).*

As the Subcommittee is aware, the Commission has asked for legislation granting it power it presently has only with respect to national securities associations—to *disapprove* proposed exchange rule changes. I do not believe, however, that it is appropriate to require the Commission affirmatively to approve proposed exchange rule changes. There are a number of reasons for my views in this regard.

First, and perhaps most important, is the fact that such a requirement—that the Commission approve each proposed exchange rule change—runs counter to the philosophy of self-regulation which pervades the Securities Exchange Act. The theory of self-regulation embodied by that Act adheres to the notion that broad initiative is vested in the exchanges to adapt their policies to the needs of investors in the public interest. Under our present system of self-regulation, the Securities Exchange Act reflects a Congressional belief that more than one approach to a given problem may exist. The Commission is not now required to agree with each action taken by the exchanges, and I see no reason to require uniform thinking on all issues.³¹ As long as exchange rule changes are not inconsistent with the objectives of the Securities Exchange Act, I believe each exchange should be free to exercise its judgment in rule making without having to conform to government thinking on how best to self-regulate. Should exchanges be required to gain the formal *approval* of the Commission before they can im-

²⁸ See p. 13, *supra*.

²⁹ See Securities and Exchange Commission, *News Digest* No. 72-52 (Mar. 20, 1972), at p. 1.

³⁰ See pp. 15-18, *supra*.

³¹ In structuring a central market system, of course, uniform regulation or comparable regulation, with respect to certain issues, may be appropriate.

plement rule changes, the concept of self-regulation would give way to what I believe more appropriately could be called direct Commission regulation.³² Such a course likely would stifle exchange initiative and nullify the creative aspects of the self-regulatory system as we know it, which have proven so beneficial to the investing public.

Such a result becomes all the more anomalous when we consider one of the primary purposes of self-regulation. In opting for self-regulation, the Congress recognized that there were practical limitations associated with a completely federalized regulatory program which could render it inefficient and self-defeating, given the highly complex and dynamic nature of the securities industry.³³ Congress explicitly rejected the concept of leaving such regulation solely in the hands of the Commission for it recognized the limitations of direct governmental regulation engendered by limited staff, limited funds and, perhaps most importantly, the difficulties inherent in the government's attempt to define ethical and moral, as opposed solely to legal, standards of conduct.³⁴

The policy considerations underlying Congress original decisions to preclude governmental establishment of moral standards of business conduct seem equally applicable and persuasive today. The exchanges properly may be concerned with a wide range of "significant" matters which fall within the realm of moral standards with which Congress was concerned. And, as noted earlier, there are additional matters which fall outside the purview of the Securities Exchange Act.³⁵ Similarly, the Commission's concern with restructuring and revitalizing the securities markets and instilling individual investor confidence in those markets, coupled with the Commission's limited staff and resources, realistically precludes any attempt to require governmental approval of all rules "of the importance of the insurance proposal," assuming that standard is sufficiently unambiguous to furnish appropriate guidelines to the Commission as to whether and when Commission approval would be required.³⁶

Moreover, the establishment of affirmative approval as a prerequisite to the implementation of exchange rule changes could require the Commission to adopt a firm position with respect to rule change proposals and deny the agency and the exchanges needed flexibility to experiment with competing solutions to existing difficulties.³⁷

In summary, I am persuaded that the implementation of the Commission's legislative proposal in this connection—the grant of Commission authority to *disapprove* exchange rule proposals—would retain allegiance to the basic concept of self-regulation, preserving exchange initiative, and yet would augment existing Commission oversight authority to insure direct and effective governmental power which has been lacking on occasion in the past, should that become necessary or appropriate.

10. *Without a written Commission opinion articulating its findings and reasons in passing on exchange rule changes of the importance of the NYSE's insurance proposals, what techniques are available to the Congress to evaluate the adequacy of the Commission's review and oversight procedures?*

The Congress traditionally has relied upon its processes of legislative inquiry and investigation to determine whether the Commission's review and oversight of self-regulatory functions is adequate.³⁸ Such Congressional review has proven effective in the past and does not raise some of the burdens and inappropriate side-effects—burdens that I have detailed in connection with my response to Question 9, *supra*, pp. 20-23—which I believe would result if the Commission

³² Compare, H.R. Rep. No. 1383, *supra*, n. 1, at p. 15: "It is hoped . . . that the occasion for direct action by the Commission will not arise."

³³ See *Hearing on H.R. 7852 and H.R. 8720 Before The House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. (1934) at 514.

³⁴ See, e.g., *Silver v. New York Stock Exchange*, 373 U.S. 341, 371 (1963) (Stewart, J., dissenting); cf. H.R. Rep. No. 2307, 75th Cong., 3d Sess., 2-4 (1938).

³⁵ See, e.g., the discussion of the McCarran-Ferguson Act, *supra*, p. 5, n. 8, and Section 6(c) of the Securities Exchange Act, *supra*, p. 2.

³⁶ I do not believe it would be as easy to establish objective standards governing those instances when Commission approval would be required, as the Subcommittee's question implies.

³⁷ Cf., e.g., *Delta Airlines, Inc., v. Civil Aeronautics Board*, 455 F. 2d 1340 (C.A.D.C. 1971).

³⁸ See, e.g., *Hearing Before a Subcomm. of the Senate Comm. on Banking and Currency on SEC Enforcement Problems*, 85th Cong., 1st Sess. (1957); House Committee on Interstate and Foreign Commerce, *Study of the Securities and Exchange Commission*, H.R. Rep. No. 2508, 82d Cong., 2d Sess. (1952); and see also, the studies currently being conducted by this Subcommittee (Sen. Res. No. 109, 92d Cong., 1st Sess., 117 Cong. Rec. S. 9506-9507 (daily ed., June 21, 1971)) and the House Subcommittee on Commerce and Finance.

were required to formulate a written opinion on all "important" exchange rule change proposals.

The Commission has in the past attempted and will continue to enunciate and articulate the basis or bases for actions it takes in this broad area of market regulation.³⁹ And, when Congress undertakes a review of the Commission's efforts in this or any other connection, the Commission furnishes as detailed a statement of the reasons for its action as is possible under the circumstances. I believe this approach is consistent with the Congress initial delegation of authority, responsibility and broad discretion to this Commission,⁴⁰ and has contributed to the Commission's effective administration of the federal securities laws that has been epitomized by the Commission's utilization of informal, flexible methods of regulation.⁴¹

While Congress, which delegated broad discretion and authority to the Commission, of course retains the power to alter this basic relationship and the existing functioning of the Commission—presumably by formalizing the requirements for Commission action or inaction—I do not believe there would be any gain in such a transformation. I believe the requirement of formal decisions would unduly encumber a system of government oversight that has, by and large, been quite effective.

11. *Is it appropriate for an exchange to assume that because the Commission has not made a "ruling" on a particular subject—e.g., arrangements whereby members will sell insurance policies of only one company—that subject is not "questionable"?*

The Subcommittee's last question, pertaining to the absence of Commission "ruling[s]" appears to be somewhat open-ended. As I indicated in response to Question 5,⁴² the Commission and its staff presently consider exchange filings concerning rule proposals in accordance with procedures that are commensurate with the importance of the proposal. Since the Commission does not, in this process, promulgate "rulings" *qua* "rulings," I do not believe it would be appropriate for the exchanges or any other interested person to glean any inferences from the lack of a "ruling" in a specified instance.

In the general consideration of rules, the Commission or its staff may comment upon an exchange rule change proposal, either informally at first (as I have already indicated) or formally. But the absence of any comment on a subject related to a rule which the Commission or its staff has considered is, by itself, not necessarily reflective of the absence of questions or problems. As with all such administrative action, the absence of any comment may have a number of "causes," depending on the particular circumstances. Foremost is whether the specific subject matter implicit in a rule proposal clearly and fully was brought to the Commission's attention by the exchange. And, even assuming such to have been the case, the lack of comment could indicate that neither the staff nor the Commission believed it appropriate to draw any conclusions concerning the collateral question embodied in the rule proposal at the same time that the rule proposal was considered or that the subject was not then deemed "questionable." In any event, the Commission or its staff subsequently, in the light of additional information or circumstances, may address itself to a specific practice.

³⁹ See, e.g., Securities and Exchange Commission, *Statement on the Future Structure of the Securities Markets* (G.P.O. ed., Feb. 2, 1972).

⁴⁰ See, e.g., the House debates on the House version of the Securities Exchange Act, 78th Cong. Rec. 7696 (1934) (remarks of Rep. Rayburn):

"We went through the bill, and everywhere that we could find a place to give authority to the Commission to make rules and regulations to govern these matters, we gave it to them."

See also, Report to Secretary of Commerce, of Comm. on Stock Exchange Regulation, *supra*, n. 15; S. Rep. No. 792, *supra*, n. 15; *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84* (72d Cong.) and *S. Res. 56 and S. Res. 97* (73d Cong.), 73d Cong., 2d Sess., pt. 16, at pp. 7596-7472 (1934).

⁴¹ See, e.g., Commission on Organization of the Executive Branch of the Government, *Report on Legal Services and Procedures* 189 (1955); Report of the Committee on Administrative Procedure, *Administrative Procedure in Government Agencies*, S. Doc. No. 8, 77th Cong., 1st Sess. 39-40 (1941).

⁴² See pp. 15-18, *supra*.

Supplementary Information Concerning Non-Securities Activities of Member Firms

[Reprinted From American Investors, August 1972]

WHAT, HOW, AND TO WHOM ARE FIRMS SELLING?

SURVEY OF 25 FIRMS REVEALS GROWING INTEREST IN NON-SECURITIES BUSINESS, PRINCIPAL ACTIVITY, AND INSTITUTIONAL SALES

Major developments, including rising costs, increased capital demands, public ownership requirements, commission rate changes, and increased regulation are forcing firms in the brokerage community to assess their future as never before.

In an effort to determine the extent to which firms are altering their business directions, American investor spoke to sources at a number of member firms. The following article, the first in a series on Wall Street's changing finances, deals with reported shifts in revenue emphasis.

Will brokerage firms two years from now be selling the same products, in the same manner, to the same customers as they are today? The answer for many is "no", as *American Investor* found out in a recent sampling of member firms. (See table.)

These firms, long accustomed to evaluating the prospects of U.S. industrial and financial corporations, are now more closely examining their own prospects, following the largest shakeout of firms from the industry in forty years.

Spokesmen for 25 firms included planning directors, managing partners, and financial officers, who reported and estimated percentage breakdowns in three categories of business for 1970, 1972, and 1974. The percentages are based on actual dollar figures for 1970 and the first six months of 1972. For 1974, they reflect, in a few instances, formal plans and, in most cases, 'guesstimates' as to how things will go in an uncertain era.

Among the more evident findings of the survey are:

A general consensus that non-securities business will be a significant factor in the revenue picture of member firms during the next two years;

An increase in principal activity, as opposed to agency activity, and projected continuation of this trend into 1974; and

A shifting of commission business toward more institutional sales for many retail and regional firms.

Implied in the comments of most surveyed sources was a need for more in-depth understanding of the profit potential in this changing environment.

NON-SECURITIES BUSINESS MAY OFFER WIDER PROFIT MARGINS

The development of non-securities business as an important source of revenue partially reflects the profit margin squeeze at most firms. Rising costs, coupled with volume discounts and negotiated commissions have caused firms to look at other areas that might offer more profit potential.

Among the opinions expressed was that the rationale for moving into the non-securities area should not stem solely from a determination to sell more products. Rather, the primary motive should be to satisfy customers' financial needs with broader financial services.

A vice president of finance at a regional firm says, "Our planning division reports a desire on the part of our customers for a one-stop financial shopping environment. Consequently, we plan to offer tax counseling and personal budgeting services. We are also investigating the potential in savings and loan, as well as advertising agency operations."

The planning director at a large retail firm provides this appraisal of the non-securities area: "All of the non-securities products we have researched work on a very nice gross. Presently, we are marketing real estate, oil drilling participation programs, and life insurance. If these products prove successful and profit potential is apparent in other areas, we fully expect to expand this list."

	Firms	Securities/Non-securities*				Agency/Principal			Individual/Institutional		
		1970	1972	1974		1970	1972	1974	1970	1972	1974
Very Large Retail (Main office location—New York; more than 50% of gross revenues in retail business; gross annual incomes of more than \$50 million.)	A	97/3	96/4	90/10		70/30	65/35	60/40	95/5	90/10	85/15
	B		N/A; increasing non-securities			80/20	70/30	60/40	90/10	80/20	70/30
	C	97/3	95/5	90/10		75/25	68/32	56/44	75/25	70/30	70/30
	D	98/2	95/5	90/10		70/30	70/30	50/50	85/15	65/35	50/50
	E	91/9	88/12	70/30		77/23	66/34	55/45	91/9	93/7	85/15
Large Retail (New York; more than 50% retail; \$20 to \$50 million.)	F	90/10	70/30	50/50		85/15	70/30	70/30	90/10	80/20	65/35
	G	100/0	100/0	100/0		95/5	87/13	77/23	90/10	85/15	85/15
	H	90/10	85/15	70/30		70/30	60/40	50/50	85/15	82/18	78/22
	I	90/10	85/15	80/20		85/15	75/25	60/40	55/45	65/35	75/25
	J	95/5	95/5	90/10		80/20	80/20	75/25	78/22	72/28	70/30
Medium Retail (New York; more than 50% retail; less than \$20 million.)	K	80/20	90/10	85/15		83/17	83/17	75/25	70/30	71/29	75/25
	L	100/0	99/1	95/5		85/15	70/30	60/40	N/A; increasing institutional		
	M	99/1	99/1	90/10		100/0	100/0	100/0	90/10	90/10	67/33
	N	100/0	100/0	85/15		90/10	90/10	90/10	40/60	50/50	62/33
	O	100/0	100/0	100/0		90/10	60/40	50/50	98/2	96/4	92/8
Institutional (New York; more than 50% institutional; gross annual incomes varied.)	P	99/1	99/1	99/1		20/80	20/80	20/80	1/99	1/99	1/99
	Q	90/10	93/7	90/10		90/10	92/8	94/6	26/74	37/63	48/52
	R	100/0	100/0	100/0		50/50	50/50	50/50	45/55	40/60	35/65
	S	95/5	95/5	95/5		40/60	40/60	35/65	35/65	40/60	45/55
	T	90/10	94/6	90/10		100/0	88/12	70/30	3/97	10/90	33/67
Regional (In Eastern, Southern, Midwestern, and Western regions; varied business concentrations and gross annual incomes.)	U	100/0	97/3	95/5		90/10	80/20	75/25	N/A; increasing institutional		
	V	95/5	92/8	90/10		90/10	N/A; increasing agency	70/30	85/15	80/20	75/25
	W	60/40	50/50	35/65		90/10	80/20	80/30	98/2	98/2	98/2
	X	98/2	94/6	89/11		80/20	80/20	80/30	65/35	75/25	70/30
	Y	60/40	69/31	71/29		86/14	87/13	83/17	46/54	29/71	28/72

*Securities: trading and underwriting of stocks and bonds. Non-securities: all others, including real estate, commodities, insurance, tax shelters, money management, etc.

SECURITIES INDUSTRY ASSOCIATION,
New York, N.Y., August 13, 1972.

MR. GEORGE E. MILLER,
Securities Industry Association,
Washington, D.C.

DEAR GEORGE: The survey about which the Senate staff inquired was conducted by our Marketing Committee in order to determine what subjects ought to be covered at a session on marketing and diversification at next week's Management Conference. I am enclosing a copy of the survey questionnaire and the results as tabulated to August 1, 1972. As you will note, most of the areas fall pretty much within the standard type of services traditionally offered by various segments of the business. What we are seeing, I think, is firms "diversifying" into a full line of service rather than contenting themselves with one or two specialties. Quite obviously they are looking for activities which are countercyclical to security commission business.

I am also enclosing a clipping from today's New York Times reporting an AMEX survey on diversification. It seems to make the same point as our inquiry.

Sincerely,

RICHARD O. SCRIBNER,
Vice President and General Counsel (New York).

SECURITIES INDUSTRY ASSOCIATION,
New York, N.Y., June 28, 1972.

To: Partner or officer in charge of sales SIA member firms.

SURVEY ON MARKETING AND DIVERSIFICATION

Prompted by the trend toward diversification and the ability of NYSE firms to sell life insurance, many firms have become interested in gaining information and the benefit of experience from others regarding these and other aspects of marketing.

The Marketing Committee of SIA has agreed to undertake a project designed to assist firms in this subject area. One possibility is a series of marketing and diversification sessions at the SIA Annual Management Conference in September.

In order to get a more precise reading on interests and needs, we are asking sales executives to complete and return the short survey form enclosed. Your reactions will be most appreciated by and valuable to the Committee.

ADRIAN L. BANKY,
Vice President and Staff Advisor to SIA Marketing Committee.

Please return by July 12 to: Securities Industry Association, Attention Adrian L. Banky, Room 1425, 120 Broadway, New York, N.Y. 10005.

SURVEY ON MARKETING AND DIVERSIFICATION INTERESTS

1. *Diversification.*—For each of the financial services shown, check those presently being offered by your firm. Then, for those not now offered, put a check in the column that best represents your degree of interest.

	Degree of interest (✓)			
	Now being offered (✓)	None	Some	Much
Sale of life insurance.....				
Real estate financing.....				
Other tax shelter investments.....				
Money management services.....				
Options—Puts and calls.....				
Commodities.....				
Financial Planning services.....				
Corporate consulting—Mergers, etc.....				
Personal tax services.....				
Mutual funds.....				
Other: Please add below:				

2. *Marketing Plan*.—A number of marketing executives in large firms believe that diversification is but one element to be considered in formulating a marketing plan. That is, the plan details the objectives; diversification is one possible means to realize the objectives in the plan. Therefore, they contend, a firm should first devise a marketing plan for itself before it plunges ahead with diversification.

Do you agree with this concept? -----

If a conference were held or manual prepared, do you feel attention should be given to how to devise a marketing plan? -----

3. *Content and Emphasis*.—Shown below are some views that have been expressed regarding the content and emphasis of a conference or manual on marketing and diversification. Please check those to which you subscribe.

- Considerable attention should be given to specifics; i.e., *how* to do it, what mistakes to avoid, how to train and staff, etc.
- The "cons" as well as the "pros" of diversification should be treated.
- Hard statistics and data should be employed.
- Should include an analysis of trends in sources of income within the industry.
- A meeting is probably better than a manual since an exchange of viewpoints and information can be elicited; there is an opportunity to probe; etc.
- Considerable attention should be focused on marketing costs; marketing within our business is not sufficiently "net oriented."

5. *Interest*.—Without making any commitment, do you feel your firm would be interested in participating in a meeting on marketing and diversification? -----Probably Yes; -----Maybe; -----Probably No. In obtaining a manual or handbook, if one is developed by SIA? -----Probably Yes; -----Maybe; -----Probably No.

6. *Your Comments*.—Please give us any thoughts you may have regarding the proposed project, what it should encompass, what it should avoid, etc.

Name----- Title----- Firm-----

MARKETING SURVEY

	Now being Offered	Degree of interest		
		None	Some	Much
1. Diversification:				
Sale of life insurance.....	31	55	44	36
Real estate financing.....	37	57	38	26
Other tax shelter investments.....	57	30	54	22
Money management services.....	64	30	30	24
Options—Puts and calls.....	51	64	31	15
Commodities.....	20	121	12	3
Financial planning services.....	45	29	51	33
Corporate consulting—Mergers, etc.....	95	23	31	14
Personal tax services.....	11	94	44	5
Mutual funds.....	116	19	25	7

Other

Portfolio Computer Revenues.
GNMA, TREAS, HEROS.
Underwriting, broker.
Municipal bonds.
Sale of mortgages and contracts.
Listed securities, municipal bonds, unlisted securities.
Private placements.
Estate administration.
Institutional research.
Limited partnerships.
Pension and profit sharing plans.
Health and accident insurance.
Oil and gas funds (for income).
Regional research.

2. *Marketing Plan*.—Question No. 1: 149 Yes; 1 No. Questions No. 2: 143 Yes; 3 No.

3. *Content and Emphasis*.—Question No. 1: 136. No. 2: 139. No. 3: 110. No. 4: 100. No. 5: 83. No. 6: 110.

4 *Interest*.—Meeting: 91 Probably Yes; 43 Maybe; 35 Probably No. Manual: 128 Probably Yes; 25 Maybe; 12 Probably No.

Total 170 responses.

SECURITIES INDUSTRY ASSOCIATION UPDATE ON SALES MANAGEMENT

August 17, 1972.

SURVEY IDENTIFIES MAJOR AREAS OF DIVERSIFICATION INTEREST AMONG FIRMS

SIA Marketing Committee recently surveyed firms to determine the extent to which firms are already engaged in various areas of diversification and the degree of interest they have in exploring new product/service areas. Major purpose of the survey: to use results in planning the S/M Section of next month's Management Conference.

Over 170 firms responded. Here is the extent to which firms are now active in these 10 areas:

- 68 percent offer mutual funds
- 56 percent do corporate counseling
- 38 percent are in money management
- 34 percent offer tax shelters other than real estate
- 30 percent deal in options
- 26 percent offer financial planning services
- 22 percent do real estate financing
- 18 percent are either in or about to be in life insurance
- 12 percent do business in commodities
- 6 percent extend personal tax services

What about interest in adding products/services to the "lines" of firms? We asked those not now offering each of the services to indicate degree to which they are interested in each. Here are the percentages that indicated "some" or "much" interest.

Tax Shelters Other Than Real Estate, 67 percent (76 of 113).

Money Management Services, 60 percent (64 of 106).

Corporate Consulting, 60 percent (45 of 75).

Mutual Funds, 59 percent (32 of 54).

Life Insurance, 58 percent (80 of 139).

Financing Planning Services, 51 percent (64 of 125).

Real Estate Financing, 48 percent (64 of 133).

Options, 39 percent (46 of 119).

Personal Tax Services, 31 percent (49 of 159).

Commodities, 10 percent (15 of 150).

An additional interesting point: of those firms that responded, 62% indicated "much interest" in at least one new product/service area—and only 4% (seven firms) said they have no interest in any new product/service area. Very few indeed are giving thumbs down to new revenue possibilities. Ted Levitt's comments next month will include the issue of what our business is.

[From New York Times, August 31, 1972]

FIRMS SHUNNING AGENCY BUSINESS

AMEX SURVEY OF 25 BROKERS CITES COMMISSION CUTS

A move toward more non-securities business and away from public agency activity has been disclosed in a recent survey of brokerage firms, the American Stock Exchange reported yesterday.

In the last six weeks the exchange surveyed 25 brokerage firms and reported the results in the latest issue of its magazine, *American Investor*. Paul Kolton, president of the Amex, said recent reductions in commission rates and the prospect of additional cuts might compel brokerage firms to accelerate plans to emphasize other revenue sources and to reduce public brokerage business.

"Paradoxically," Mr. Kolton observed, "this is occurring at a time when Congress, the Securities and Exchange Commission and the securities industry have all agreed on the need for broad public participation in the market."

MAJOR FINDINGS

Among the major findings of the survey were the following:

¶Non-securities business is expected to become a significant factor in the revenue picture of member firms during the next two years.

¶Commission business is shifting toward more institutional sales for many retail and regional firms.

¶Increased principal activity, as opposed to agency activity, has been projected to continue into 1974.

In agency business a stockbroker represents a customer as an agent and is compensated in the form of a commission. In principal business a broker acts as a principal in a transaction and is compensated by trading at a profit for his own account.

The president of one leading firm that was included in the survey commented:

"Further institutionalization and centralization of the marketplace along with another drop in negotiated rates on agency transactions could well push firms into doing more and more principal business, market making, positioning big blocks, getting off more secondaries and exchange distributions, syndication and new issues."

A spokesman for one brokerage firm participating in the survey estimated that by 1974 his firm's principal activity would be five times greater than its 1970 proportion and that, if the level of negotiated commissions continued to decline, principal business could rise to almost 100 per cent.

"At present," the planning director of a large retail firm added, "we make more money on a principal trade and would see this income rate continuing."

All 25 firms surveyed agreed that they did not expect to be operating in the same way one or two years hence and most expected to see a significant increase in their non-securities business. This might include, they indicated, selling life insurance or providing general financial counseling.

The vice president of a regional firm observed: "Our planning division reports a desire on the part of our customers for a one-step financial environment. Consequently we plan to offer tax counseling and personal budgeting services."

**Letter and Attached Questions Sent on September 21, 1972, to Witnesses Who
Testified at October 5, 1972, Hearing Which Follows**

DEAR MR. ———: On October 4, the Subcommittee on Securities will hold the final hearing in its current study of the operation of the regulatory system in the securities industry.

Previous hearings in this series were focused on particular examples of the operation of the regulatory process. The purpose of this final hearing will be to obtain the general views of representatives of the regulatory organizations as to how the system is working and whether and how it should be modified.

You are therefore invited to testify before the Subcommittee at 10:30 a.m. on October 5, 1972, in Room 5302, New Senate Office Building, and to submit a written statement of your views on the structure and operation of the regulatory system in the securities industry. Your oral presentation, if you wish to testify in person, should be limited to fifteen minutes; your written statement may cover whatever issues you believe to be important in this area, and the full text will of course be included in the record of the hearings.

Specific questions with which the Subcommittee is particularly concerned are set forth on the attached sheet. It would be most helpful if your written statement contained answers to these. To the extent that your answers can be illustrated or supported by actual examples of regulatory conduct, either those developed in the case studies or others, the Subcommittee will be in a better position to evaluate the soundness of proposed changes in the system.

Sincerely,

HARRISON A. WILLIAMS, Jr.

QUESTIONS REGARDING THE REGULATORY PROCESS

1. What suggestions, if any, would you make for reallocating authority among the various self-regulatory agencies? Over which firms, and which activities, should each of such agencies exercise effective authority?
2. What rules should apply to the composition of the governing boards of the self-regulatory agencies, and to the manner of selecting members of those boards?
3. What suggestions, if any, would you make for improving the procedures followed by the self-regulatory agencies in adopting rules and policies, and in conducting disciplinary proceedings?
4. What do you consider the appropriate legal and operational relationship between the self-regulatory agencies and the SEC? What are your views on the SEC proposals, embodied in H.R. 15303, with regard to the SEC's authority over actions of the self-regulatory agencies?

SELF-REGULATION IN THE SECURITIES INDUSTRY

THURSDAY, OCTOBER 5, 1972

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The Subcommittee met at 10:15 a.m., pursuant to call, in room 5302, New Senate Office Building, Senator Harrison A. Williams, Jr. (chairman) presiding.

Senator WILLIAMS. We are very pleased to have this most knowledgeable and distinguished panel of witnesses as we complete the public hearing phase of our study of the regulatory system in the securities industry.

The Subcommittee is privileged to have as its witnesses distinguished representatives of the Securities and Exchange Commission and of the major self-regulatory organizations; the National Association of Securities Dealers and the American, Midwest, New York, Pacific Coast, and Philadelphia-Baltimore-Washington Stock Exchanges.

I have asked these witnesses to offer their suggestions for improvement of the self-regulatory system, focusing particularly on four key areas: The allocation of responsibility among the various agencies, the makeup and selection of the governing boards of the self-regulatory agencies, the procedures followed by the self-regulatory agencies in their rulemaking and disciplinary proceedings, and the appropriate relationship between the SEC and the self-regulators.

In addition to these hearings, the Subcommittee has undertaken four case studies of the operation of the regulatory system.

Two of these case studies, dealing with the inclusion of listed securities in NASDAQ and the sale of life insurance by stock exchange members, were released in August.

Two additional studies, dealing with evaluation of specialist performance and administration of net capital rules, are now being completed.

I expect to release these shortly, accompanied by statements setting forth the views of the regulatory agencies involved.

With the knowledge gained through these case studies and with the guidance our distinguished witnesses will offer us today, I hope the subcommittee will be able to make constructive recommendations for the improvement of the regulatory process to provide greater protection for public investors.

The Subcommittee report embodying those recommendations will be completed by the end of this year.

As you know, gentlemen, they have called a live quorum now prior to a cloture vote. We feel this is the best way to approach this, with all of you here as a panel, and I know you have your individual statements. Why don't we get underway, Commissioner Loomis, and when the break comes, it will only be for about 10 or 12 minutes.

STATEMENT OF PHILIP A. LOOMIS, JR., COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. LOOMIS. Thank you, Mr. Chairman.

I am very pleased to participate in this, the last of your Subcommittee's three hearings concerning the operation of the regulatory system in the securities industry. The hearings today, unlike the predecessors, are concerned with the broader subject of whether the unique system of self-regulation in the securities industry is working and whether and how it should be modified. In preparing my remarks for this hearing, I have, in accordance with the Subcommittee's request, endeavored to respond to the four rather all-encompassing questions concerning this important topic which were attached to Chairman Williams' letter. However, these are very broad and important issues; and in view of the shortness of time and the fact that these questions can effectively be answered only after the issues concerning the future structure of our securities markets are resolved, I cannot provide definite and comprehensive answers. Indeed, as to some of these questions, I doubt if such answers now exist.

The fundamental concept of self-regulation embodied in the Securities Exchange Act was well suited to the securities markets as they existed in 1934 and 1938. In light of the rather extensive changes in the securities markets and trading patterns that have occurred in recent years, however, some observers have concluded that self-regulation is no longer viable. Based upon our experience, however, the Commission cannot subscribe to this view. The system of self-regulation has served, in many areas, as a source of affirmative protection to public investors and as an important vehicle to implement the regulatory objectives of the Congress.

Nevertheless, the magnitude and rapidity of the changes in our securities markets and the resulting changes in the nature of the issues which confront all concerned with the regulation of those markets, including the self-regulatory agencies, have thrown a considerable strain upon the existing pattern of self-regulation which has, in turn, revealed certain weaknesses.

In earlier years, the self-regulatory agencies were conceived of as primarily designed to establish and enforce standards of personal conduct in the securities industry. To this task, they were expected to bring, and did bring, an awareness of the standards voluntarily observed by responsible members of the industry, and also a day-to-day familiarity with what was going on and what was right, or wrong about it. The self-regulatory agencies have in the past, and continue at present, to make a major, and I think irreplaceable, contribution in this area.

More recently, however, the self-regulatory bodies have been confronted, by changing conditions and changing needs, with the resolution of economic issues, which bear directly not only upon the economic

interests of their members, but upon the economic interests of non-members as well. In addition, as I will discuss further in my answer to your first question, the various markets have become so closely inter-related that certain issues are highly significant to more than one such agency, and it becomes difficult to resolve these issues at an industry level without the concurrence of several self-regulatory agencies. Resolution of such common problems may be impeded by the fact that any given resolution may be seen as either advancing or as impairing the economic position of the members of a particular self-regulatory agency in relation to the members of another such agency.

Problems of this kind elude prompt and simplistic solutions. They can and should be examined and resolved by collective and carefully considered efforts of the self-regulatory bodies, the Commission, and Congress. But I believe that there is no need to abandon or unduly encumber a system that, in many instances, has been responsive in the past to the public interest and that can be made more responsive in the future.

Turning now to your first question concerning reallocation of authority, in its recent report, the House Subcommittee on Commerce and Finance noted that "the overall organization of the markets is now in flux * * *." What they had in mind, I believe, was the conclusion generally shared that there should be an evolution of centralized market system, with open access by all qualified brokers and marketmakers. The Commission has indicated its concurrence with that view in its February policy statement.

Until the parameters and scope of the central market system are more sharply in focus, it is exceedingly difficult to determine how responsibility should be allocated among regulatory agencies. When the existing system was evolved, it appears to have been based upon the assumption, then reasonably valid, that each exchange and the over-the-counter market, was more or less a self-contained entity. It was accordingly concluded, notwithstanding the fact that particular firms could, and did, do business in more than one market, that it was nevertheless appropriate for there to be a self-regulatory body for each such market.

At present, the various markets are not, if they ever were, self-contained entities. Many regional stock exchanges now deal primarily in securities listed on the New York exchanges, rather than in local securities. There has evolved an active over-the-counter market in exchange listed securities. Securities firms doing business with the public increasingly tend to specialize in one type of business, such as serving institutional or serving retail customers, rather than specializing in doing business in a particular market. This development raises difficult questions concerning the allocation of responsibilities among self-regulatory agencies, some of which I alluded to earlier in this statement. They have led some observers to suggest a drastic realignment under which all responsibilities for self-regulation would be confined to one agency, confining itself exclusively to self-regulation, while other agencies would be responsible for the problems of operating the particular markets. It is not clear, however, whether self-regulatory responsibilities can practically be separated from operational responsibilities, although if this were practicable, it would simplify matters by sharpening the focus of each agency's responsibilities.

I do not believe these questions can be resolved until we see more clearly the structure and nature of the markets to be regulated, including particularly the evolution of the central market system.

With respect to the composition of the governing boards of the self-regulatory agencies, that subject was a matter of deep concern to the Congress when it adopted both the Securities Exchange Act in 1934 and the Maloney Act in 1938. The Commission was, in 19(c) of the Securities Exchange Act, directed to make a study, among other things, of the rules of national securities exchanges with respect to the methods employed to elect officers and committees to insure fair representation of the membership of these exchanges. The Commission, in its study, made a number of recommendations for voluntary, as opposed to legislative, changes with respect to the government of the exchanges, and many of these were implemented by the exchanges.

The legislative history of the Maloney Act makes it clear that the securities association it envisioned was to be, strictly speaking, a "democratic organization," and Congress was very much concerned that domination by any particular segment or oppression of any particular segment was a real evil to be avoided.

I am inclined to believe, therefore, that there should be some basic standard such as is now found in 15A(b)(6) of the Securities Exchange Act, to "assure a fair representation of its members in the adoption of any rule * * * or amendment thereto, the selection of its officers and directors, and in all other phases of the administration of its affairs." The NASD and the exchanges have both implemented this objective, although the statute commands it only for the NASD.

Recently, as you all know, the New York and American exchanges have reorganized to provide that almost half of their governing board positions shall be filled by public directors. And, the NASD has amended its bylaws to permit its board of governors to select one or more governors-at-large from the public, and has just announced in the last day or two the selection of A. A. Sommer of Cleveland, Ohio, as another one. I have known Mr. Sommer for many years. He is an extremely able and public-spirited citizen and I think he will be a great asset to the NASD and the financial community.

We applaud these responses by the exchange and the NASD and feel that the composition of the governing bodies could be much improved by this, although it is a little too early to say how the system would work. I should note, as I did not in my statement, that the New York Stock Exchange has appointed a counsel to the independent members of the board, public members, in order to help them with their work, and this seems to me a very useful idea.

Turning now to procedures followed by the self-regulatory agencies in adopting rules and policies and in conducting disciplinary proceedings, as I indicated in my introductory remarks to these hearings on August 8, the Act says very little about the internal decision-making processes of the self-regulatory bodies as distinct from the substantive standards to which their decisions must conform; and accordingly, they evolved a general pattern modeled on that in use by other nonprofit corporations, and they are now only moving a little away from that.

With respect to the adoption of rules, it is my opinion that the self-regulatory bodies should be required to afford an opportunity for general public comment on all proposed rules having any significant impact, either upon their membership as a whole or, particularly, upon nonmembers. The self-regulatory bodies already are making valuable efforts to implement this objective. For example, the NASD is increasingly exposing its rule proposals to public scrutiny and comment, and, as I have already indicated, the major exchanges are significantly expanding public participation in their governing boards.

And, I note, just recently, the American Stock Exchange submitted to the Commission a proposal to accord Exchange members and other interested persons an opportunity to comment upon major rule and policy proposals before their final adoption by the exchange's board of governors. I have a copy of the Amex letter filing this with us attached to my statement. The New York Stock Exchange has also indicated that they favor disclosure of rule proposals and opportunity for comment either through the Commission or perhaps otherwise. I am in accord with the philosophy embodied in these policies.

Similar developments have occurred with respect to self-regulatory disciplinary proceedings. In the last several months, both the New York and American Exchanges have submitted proposals to revise their procedures. No doubt, they will discuss them in more detail in their statements. This is one area where the Commission has recommended that it be given greater powers of governmental oversight than presently exist.

The Commission also is considering the recommendations of its Advisory Committee on Enforcement Policies and Practices concerning increased publicity for self-regulatory disciplinary proceedings, and some such publicity is occurring. In general, I believe the self-regulatory bodies have shown themselves willing to experiment and innovate in this area.

I think that it would be unfortunate if they were required to adopt the whole panoply of Government administrative procedure as embodied in the Administrative Procedure Act, as I said in my written statement. In the first place, these are not Government agencies; and in the second place, administrative procedure in Government agencies is not without its problems.

Turning now to the appropriate relationship between self-regulatory agencies and the SEC, the Congress established the self-regulatory system and gave it considerable autonomy. Nevertheless, the Congress at the same time made the essential decision in 1934, when it determined to establish governmental supervision and oversight over the existing self-regulatory activities of the exchanges, on the ground that public policy demands that private bodies exercising what essentially are governmental powers should be subject to adequate public supervision through a governmental agency. That decision was sound then and it is sound now. The changes which I have referred to in the very nature of the responsibilities and functions of the self-regulatory agencies call for a reexamination of the somewhat uncoordinated pattern of oversight which was provided in various statutes enacted primarily between 1934 and 1940. They further call, in my opinion, for a strengthening of the Commission's oversight authority by reason of

some of the problems which the Subcommittee has observed and which I have referred to.

I will not go through the whole history of discussion of self-regulation here, but I do believe that the public interest requires that the Commission's residual powers must in fact exist and be clearly delineated. The Commission should have a mandate from the Congress to empower it to interpose its authority directly when this is necessary in the public interest, and the Commission should be given that authority. Accordingly, I believe the proposals embodied in H.R. 15303 merit your careful consideration and approval. We have submitted to Congress detailed explanations and justifications for this legislation.

In conclusion, self-regulation is, I believe, a valuable and probably necessary component in the regulation of this large, diverse, exceedingly complex and very important industry. Such self-regulation must be adapted as rapidly as possible to the changing needs and problems of today and of the future. Commission oversight over this self-regulatory process, which Congress also found essential, must be retained and adapted to present conditions, which I think means that it should be strengthened. Ever since 1934, any proposal to grant power to the Commission has been met with the objection that such power could be used with a reckless disregard for the underlying purposes of the Congress. I think the record over the years demonstrates that this concern is unfounded. I think this has not been done in the past and I am confident that it will not be done in the future, particularly in view of continuing congressional oversight.

Thank you.

(The full statement of Mr. Loomis may be found at p. 238.)

Senator WILLIAMS. Thank you very much.

We will break here. I will be back very shortly.

(Recess.)

Senator WILLIAMS. Now, we can reconvene with the testimony of the president of the National Association of Securities Dealers, Gordon S. Macklin.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. MACKLIN. Thank you for the opportunity to appear today and express some additional opinions about the operation of the regulatory system of the securities industry.

It should not be surprising for you to learn that in our opinion this regulatory system is effective and the concept of cooperative regulation is a good one. We recognize that there have been times in the past when there have been difficulties with this system, and we are among the first to admit that changes could and should be made, but in doing so, we strongly advocate that preservation of the cooperative regulatory pattern we live with since it harnesses a large amount of unique industry expertise to complex regulatory problems.

Our written statement (p. 273) contains the answers to each of Senator Williams' four questions. I would like to briefly summarize these answers in the next few minutes.

We feel that the question of how to reallocate authority among self-regulatory agencies exposes fertile areas in which to grow improvements for the future. We recognize that this concern is shared by many

of the other self-regulatory agencies. We also recognize that a comprehensive reallocation program should be postponed until we have a clearer view of the market system of the future.

However, we feel that some steps should be started now to reduce some of the cost and duplication that currently exists. Our association has a network of 14 branch offices covering the country from Seattle to Boston. These offices are manned with well-trained and experienced people and we believe that they could materially assist many of the exchanges wishing to coordinate their out-of-town regulatory efforts with ours on a cost sharing basis.

We have discussed the concept of a joint examination program with Chairman Needham of the New York Stock Exchange, and next Thursday, the two top officers in our regulation departments will meet with their counterparts at the New York Stock Exchange to continue these discussions and work toward a pilot program of joint examinations. We would be willing to explore a comparable pilot program with any of the regional exchanges.

There appear to be two obvious ways to reduce member costs in the regulatory effort. First is coordination of the inspections by the various regulatory agencies in order to reduce the disruption to our members' day-to-day operations. Additional savings will come when the various regulatory agencies have a comprehensive program of sharing information such as examination reports concerning joint members. Such a sharing should enable all regulatory agencies to do a better job more efficiently.

On the subject of directors, as you know, the Maloney Act requires that members of our Board be elected in a fair and democratic manner and the Securities and Exchange Commission has the power to assure that we live up to this mandate. Our Board consists of governors elected from all parts of the country and a close analysis will show that our governors are from firms of various sizes and represent a variety of backgrounds in the industry. At this moment, for example, there is a governor who is a principal in a very small firm in Portland, Oreg.; while another is an officer of Merrill, Lynch, Pierce, Fenner & Smith. Various governors have expertise in such specialized areas as operations, trading, money management, retail sales, and administration. We feel that the job of regulating a complex market mechanism without strangling it can best be done by using the unique expertise of industry leaders.

Since the Association's various committees employ, on a donated time basis, about 300 people from the industry per year, a worthwhile byproduct of our system is the fact that there are now many people in the industry doing a better job of conducting their business because of the experience gained while working in the self-regulatory process.

We do recognize the potential benefits to be gained from hearing views from knowledgeable people not directly employed in the securities industry. We have three positions for governors-at-large which can be filled from people outside of the securities industry. As of January 15, 1975, two of these positions will be held by Dr. James H. Lorie, of the Graduate School of Business, University of Chicago; and A. A. Sommer, Jr., a prominent attorney and chairman of the American Bar Association's Committee on Securities Law.

The Association has no limit as to the number of members and is prohibited by law from embracing a schedule of fixed commissions. As a result of these factors and the close SEC oversight, our situation is substantially different from an exchange and thus we do not feel it is appropriate to adopt a restructuring similar to that of the New York Stock Exchange.

In response to question three, since 1970, we have followed a procedure whereby we send proposed rules out for comment to members, the bar and other interested parties before adoption. Although this system is expensive and time consuming, we have benefited from the comments which, for the most part, are of high quality and thus we feel that this procedure is a good one.

Recently, we have experimented with another change, in that we have added people from outside the industry with specialized legal and accounting experience to a committee of industry experts to consider the Securities and Exchange Commission's request that we formulate additional rules concerning new issues. Although it is too early to tell, we suspect these experts from outside the industry will make such a contribution that we will continue to draw on outside assistance in the future.

The brief answer to question No. 4, as to our relationship with the Securities and Exchange Commission, is that it has been excellent. From time to time our views differ, but this is as it should be since this interchange of ideas results in mutual understandings.

Recognizing the committee's continuing study and interest in the NASDAQ system and the National Clearing Corp., we included in our written statement some comments concerning them.

NASDAQ started operation on February 8, 1971. At that time, 2,300 securities were quoted in the system and the computers were handling about 350,000 calls per day. Our written statement on page 11 has an error in that it shows 250,000 calls per day. Today, there are in excess of 3,400 securities being quoted, and the average number of calls per day is about 1,250,000. Daily trading volume recorded NASDAQ on most days is well in excess of twice the total volume on the American Stock Exchange and, in fact, exceeds the combined total volume on all exchanges in the country except the New York Stock Exchange. Future plans for the system include the implementation of a trade reporting program and eventually a direct linking of the data from this program with the clearing operation of the National Clearing Corp.

The National Clearing Corp. has been operating in New York City since October 15, 1971, using a continuous net method of settling over-the-counter transactions. Recently, pilot operations were implemented to include Boston and Philadelphia through the facilities of the regional stock exchanges in those cities. This is in addition to a pilot we have for interarea clearing between New York and the west coast through the facilities of the Pacific Coast Exchange. These pilot operations are currently being expanded. Recent discussions with the Midwest Stock Exchange have indicated that the National Clearing Corp. will be operating in Chicago through the facilities of the Midwest Stock Exchange Clearing Corp. before the end of this year. We plan to commence operations in a number of additional key

cities throughout the country and hope to be operating on the west coast through the facilities of the Pacific Coast Stock Exchange before the end of next year. It is important to note, however, that even at this early stage the National Clearing Corp. is handling approximately 10,000 to 15,000 trades per day and, thus, is the second largest stock clearing organization in the country. Our goal is to process 35,000 to 50,000 trades when the system is expanded to cover all national trading areas in the country.

The NASDAQ system has created for the Association a vehicle for entry into market surveillance via regulatory reports which are produced in a NASDAQ issue whenever it exceeds certain predetermined price or volume parameters. Many of these parameter breaks are obviously routine instances of price and volume fluctuation. However, the staff of the association's new stock watch department established for the purpose of reviewing and detecting possible manipulation, has of the 487 cases it investigated since its establishment in January 1972, referred 13 to the SEC for further investigation of possible violations of the Federal securities laws and six to the association districts for investigation of potential violation of the association's rules. This material, coupled with reports generated by the National Clearing Corp. as to dealer trading activity and capital and operating condition, substantially improves our ability to effectively regulate activity in the over-the-counter market.

In sum, we feel that we are progressing rapidly along the road toward a well-regulated and highly automated over-the-counter market with access open to all qualified dealers. Needless to say, we greatly appreciate the help we have received with these programs from Congress and the Securities and Exchange Commission.

(The full statement of Mr. Macklin may be found at p. 273.)

Senator WILLIAMS. Thank you very much, Mr. Macklin.

Mr. Paul Kolton, of the American Stock Exchange.

STATEMENT OF PAUL KOLTON, PRESIDENT, AMERICAN STOCK EXCHANGE

Mr. KOLTON. Thank you, Mr. Chairman.

The Amex welcomes this opportunity to express its views and I would like to summarize very briefly our comments, first, as to the question of the self-regulatory process itself: and then, the specific questions that the Committee has raised.

I think most of the authorities who have looked at the question of self-regulation have endorsed the concept while criticizing certain aspects of its operation. It is worth taking just a moment to examine the reasons that the self-regulatory system is preferred.

These reasons would certainly include the advantage of expertise and closeness to the markets, the ability to enforce ethical standards which go well beyond purely legal standards, the ability to make a regulatory system much more responsive to tough-minded self-discipline, and, finally, the recognition that industry and not government should bear the regulatory cost.

It is interesting that, going back in time to 1934, one of the original framers of the securities laws looked at the alternative to self-regula-

tion and he said that as a practical matter, "It brings with it the sheer ineffectiveness of attempting to exercise regulation directly through government on a wide scale."

We believe that the self-regulatory process is indeed the most effective one and at the same time we recognize that it is imperfect and sometimes it is untidy, but we think that in the perspective of the years it has enabled the industry and the millions of people that it serves to make a singular contribution.

There is something about an effective self-regulatory mechanism that requires a very delicate balance in the exercise of government power. There is a natural tendency on the one hand to wield government power directly and on the other hand there is the risk, and it is a real risk, that failure by government to oversee and coordinate the activities of the self-regulatory organizations will impair public confidence in the market. We think both of these extremes must be avoided. There certainly is a danger, in our view, in the development that if the SEC is given more direct administrative responsibility in the operation and regulation of the markets, self-regulation will become more a matter of form than of substance. So we think it is vitally important that Congress and the SEC realize in their efforts to correct past problems and to create the securities markets of the future, that the self-regulators need to retain sufficient latitude to encourage initiative and to discharge their regulatory tasks boldly. Therefore, we approach the questions that the Subcommittee has posed with these thoughts uppermost in our mind.

As to the first question, dealing with the possible reallocation of authority among the various agencies, it is our view that since most of the broker-dealers and certainly many of the larger firms in the industry are members of several exchanges as well as the NASD, a certain amount of overlapping of functions and responsibilities is inevitable. We recognize, of course, that major investigative and enforcement actions are likely to involve a variety of member-firm activities and it is important that the self-regulatory organization retain broad authority to take necessary action in any aspect of a member firm's business.

We have had a series of experiences which would indicate that an investigation launched by the Exchange that begins as a rather humble inquiry into a trading situation may lead to substantial questions being raised involving the firm's underwriting activity or its handling of customer accounts or its overall supervisory procedures or other aspects of its business.

We would, therefore, not recommend at the present time that the scope of authority and responsibility of the self-regulatory organizations be restricted or compartmentalized to particular types of activities or functions, even though, theoretically, there may be some potential overlap. To a great extent, duplication has been reduced through arrangements among the self-regulatory organizations for the allocation of regulatory authority and for joint reporting of critical information. In another area, there has been a virtual elimination of duplicate member firm examinations and screening of the background of applicants for membership or registration as salesmen. By and large, these allocation arrangements have worked efficiently. While problems have arisen from time to time in coordinating the flow of information

among the self-regulatory organizations, such problems have been dealt with effectively once they have been identified, and we are continuing to develop procedures for more effective coordination with other self-regulatory organizations and with the SEC. We are confident that further improvements will be made in this area.

When we look to the future, it is clear to us that the establishment of the central market system will clearly provide an opportunity to assess in what is then a current setting the present arrangements for allocation of authority. Pending the development of such a system, whose specific shape we do not yet know, we think it is premature to make any specific suggestions for the relocation of authority among the self-regulatory agencies.

As to the second question that the Committee has raised, the composition of the governing boards of the self-regulatory agencies, I think it is clear that there has been a series of dramatic developments over the past several months. A number of the self-regulatory organizations have, on their own initiative, taken major steps to reorganize their governing structure and provide substantially more public representation.

This week, for example, the Exchange's nominating committee which itself had 50 percent of its members representing the public, announced the names of a new slate of nominees for the board. That new slate includes 50-percent public representation and the public members include a distinguished group of lawyers, economists, educators, business executives, and representatives of the media. I think it is important and often overlooked that this significant reorganization was neither prompted by nor imposed by an agency of the Government. Rather, it was designed and implemented independently by the membership in recognition of the exchange's expanded public role and responsibility.

These major changes, which are as a practical matter irreversible, must be tested over time. As experience is gained under the restructured system, the Exchange would expect to make any adjustments which may appear desirable. But in view of the steps already taken by the Amex, and by other self-regulatory organizations, we do not believe that either specific SEC rules or legislation is required.

As to improving procedures of the self-regulatory agencies in adopting rules and policies in disciplinary matters, your Committee's third question, the Amex has continually explored ways in which these procedures can be made more responsive. Even before the reorganization, we had recognized that it would be necessary to develop and formalize a procedure to permit members of the investing public to comment on all major proposed rule and policy changes.

As Commissioner Loomis indicated, the Amex board last month approved and submitted to the SEC a proposed policy statement under which the Exchange will publicize proposals to adopt new rules or policies, or to amend or rescind existing rules or policies, before the board takes any final action with respect to such proposals. Under these procedures, major policy matters affecting the Exchange, its membership, listed companies or public investors will be published, comment sought, and hearings held, where required, before the exchange takes a final action.

We think that the decision by the Exchange to move in this direction not only constitutes an additional step in moving toward a greater

degree of responsiveness, but we think it will assist the SEC in fulfilling its own responsibilities to review proposed self-regulatory rules and policies and in gaining additional insight into their public impact.

As to our disciplinary procedures, those, too, have been revised. In the future, they will provide for the right to counsel. They will provide for a diligent right of review. They will provide for a hearing panel made up of a jury of the accused's peers. These steps, too, are part of a trend in which the exchange is moving toward a wider public.

As to the Committee's fourth question, the appropriate legal and operational relationship between the self-regulatory agencies and the SEC, we would like to say here that the views that we are pleased to express are those of the exchange administration. On these questions, we have not had an opportunity to review them in detail with the board, but in the event that proposed legislation is introduced we would certainly appreciate the opportunity to offer definitive and detailed comments.

We concur at the outset with the SEC's view expressed in its "Unsafe and Unsound Practices of Brokers and Dealers" report that it is essential that the SEC be deeply involved as an overseer of the self-regulatory process. At the same time, we think that the self-regulatory organizations should retain sufficient independence to enable them to exercise their initiative—vigorously and broadly when that is required—on regulatory matters within their authority.

We think it is entirely appropriate for the SEC to have the power to require the self-regulatory organizations to adopt, amend, or rescind their rules which affect the public interest. We think, beyond that, that the procedures for exercising such authority should be simplified and clarified, and we believe it is appropriate for the SEC to review exchange disciplinary actions and other particular applications of exchange rules.

But we do not believe it would be in the public interest, however, to give the SEC authority to enforce exchange rules or to increase penalties in exchange disciplinary actions. We are concerned here that over time such a step would debilitate the self-regulatory process and the people charged with administering it. We think that what would happen is the responsibility would be fractionalized and that such a step would violate the tenets of both good management and good government which hold that responsibility should be clearly and unequivocally assigned. In this case, we think the self-regulatory agencies are able to accept that assignment.

There is, of course, the old question—without such power can the SEC properly protect the public interest? The fact is that most serious violations of exchange rules which might make direct action against an exchange member by the Commission appropriate would be matters that are also within the existing statutory authority of the Commission. However, the ability of an exchange to compel compliance with ethical standards would be impaired by such direct use of governmental power. Therefore, our concern is that the possible marginal benefits which might flow from SEC authority to enforce exchange rules would be substantially outweighed by the significant damage which could be done to the self-regulatory system.

Thank you, Mr. Chairman.

(The full statement of Mr. Kolton may be found at p. 269.)

Senator WILLIAMS. Thank you very much.

Now, Mr. Michael Tobin, of the Midwest Stock Exchange.

STATEMENT OF MICHAEL E. TOBIN, PRESIDENT, MIDWEST STOCK EXCHANGE

Mr. TOBIN. Mr. Chairman, the Midwest Stock Exchange welcomes this opportunity to discuss the very important subject of regulation and self-regulation of the securities markets and of the securities business.

Although the structure of the securities markets and of the industry is obviously in the process of great change, and one of the most important changes undoubtedly will be in the direction of greater competition in the performance of many functions, we do not share the view that greater competition will dispense with the need for strong regulatory and self-regulatory systems. Greater emphasis on competition undoubtedly will modify the regulatory need to one degree or another in various places, but in our judgment there will always remain very important areas where regulation will be essential to assure basic standards, to assure fair field of competition, or simply to deal with subject matters not particularly touched by competition.

At the same time, even though we feel certain that the regulatory system will continue to be of great importance in a restructured market system, we think it is probably premature to try to define the shape of future self-regulation or cooperative regulation until the future structure becomes somewhat clearer.

By way of illustration, in the 1934 act, self-regulation is based on membership in separate exchanges; and membership is defined in terms of economic differences with respect to commission rates. We are in a period of new and still very fluid concepts concerning relationships of markets to each other, commission rates and access, the role of competition in relation to regulation, the number and types of member firms, the role of automation, and other matters. Since the allocation of regulatory responsibilities obviously must be adapted to the operational realities of the securities markets and securities industry, it will be much easier to come to a sensible allocation after there has been further crystallization in some of the areas mentioned.

Although there is undoubtedly room for better coordination and possibly for some consolidation, we believe it is essential to stop far short of relying on any single, monopolistic self-regulator, or even two self-regulators dividing the field. For many reasons, we believe that competition among a number of marketmakers, market centers, and market regulators is greatly preferable to any monolithic approach. Even if concentration in a single agency or two would provide greater short-term economy, in the long run we believe it would be at the expense of dynamism and progress.

There is another reason why we doubt the advisability of thinking in terms of just two regulatory agencies, one dealing with markets and the other with firms, as some are apparently suggesting. Between internal market regulation on the one hand and financial regulation of member firms on the other hand, there is a wide gamut of other regulatory activities; and this may become wider as member firms expand the

scope of their operations into new fields. For example, to the extent that there is a self-regulatory obligation relating to an activity that is not conducted within a securities market in the normal sense—for example, commodities, insurance, real estate syndication—it is not clear that the self-regulatory arm of any particular market or market center is in a better position than another to engage in the necessary regulation. It is even less clear that any single agency, except one of enormous size and power and elaborately structured on a regional and/or functional basis, could be expected to cope effectively with the multiplicity of regulatory needs. The securities industry involves a great number and variety of activities conducted in many different combinations by a large number of firms. It does not conform to any neat, symmetrical pattern, and such pattern as there is is constantly changing. Instead of attempting to concentrate self-regulation of this pluralistic and dynamic business in a single, highly structured agency, it seems to us that the total regulatory job can best be accomplished through a looser, more pragmatic system of separate but coordinated agencies.

Of course, whatever reallocation of regulatory responsibilities may occur, it is obviously desirable to avoid unnecessary duplication of regulation, which is costly and burdensome to regulators as well as to those regulated.

As to the procedures of the Commission and the self-regulators, we may have some comments in a fuller statement which we expect to file at the conclusion of these hearings. For the present, we would simply say that there is too great a variety of regulatory activities to fit everything into a single procedural mold. Procedures should be flexible and adaptable, so that different types of matters can be handled appropriately in light of their novelty, complexity, importance, and impact on others.

I would like to conclude with a few more specific comments on the position of the Commission in the regulatory system. In general, we feel that the Commission's supervisory jurisdiction ought to be as broad as the self-regulatory obligations of each agency. Alternatively, if the Commission's authority is not as broad as the agencies' responsibility, then the law ought to make clear that, even without Commission review, there is an antitrust exemption for action taken in good faith to achieve a self-regulatory purpose.

In performing its oversight role, the Commission should attempt to speak as unambiguously as possible as to what it is requiring, approving, accepting, or not passing on. Further, to the extent possible, the Commission should acknowledge changes and refinements in its policies and procedures as they are in the process of development. In our judgment, greater certainty on the part of self-regulators with respect to the position of the Commission in those areas in which it exercises jurisdiction cannot but be helpful in achieving common regulatory objectives.

Whether the term "self-regulation" or the term "cooperative regulation" be used, the self-regulators should be encouraged to be responsible, dynamic participants, or partners in the process, and not mere instruments of the Commission. While, as suggested above, Commission oversight should ordinarily be as broad as self-regulatory responsibility, there should continue to be ample scope for self-regulators to take the initiative and exercise independent responsibility without undue Commission intervention. We would, therefore, generally

favor the expansion of the Commission's supervisory role as proposed in H.R. 15303, on the assumption that the Commission will continue this general approach of leaving initiative and responsibility to the self-regulators to the greatest possible extent. However, we have some doubt as to the appropriateness of the procedure that is proposed with respect to amendment of the rules of an exchange under section 9 of the bill (amending section 19(b) of the Securities Exchange Act of 1934) whereby the Commission would act by rule under section 553 of title 5 of the United States Code without the necessity of a hearing "on a record." We reserve the right to make further comment on this and other aspects of H.R. 15303 in our fuller statement at the conclusion of these hearings.

(The full statement of Mr. Tobin may be found at p. 294.)

Senator WILLIAMS. Thank you very much.

Donald Calvin, vice president of the New York Stock Exchange. Every one of you witnesses have made this a second home, have you not? It is good to see you back again, all of you, by the way. I forgot to mention that.

STATEMENT OF DONALD L. CALVIN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. CALVIN. I speak on behalf of the New York Stock Exchange, and I am personally pleased to be here and always welcome the opportunity to address this committee and particularly if we have a colloquy with its chairman.

As we say in our prepared statement, I think that the hearings that this Committee has held over the past several months, as well as other committees of Congress have had, dealing with the matters related to the securities industry, have been constructive. They have identified and explored various problem areas in the industry, and they have given us valuable guidance as to areas where constructive change is needed.

We—that is to say, the industry, and especially speaking on behalf of the New York Stock Exchange—have not been sitting back complacently. I think the chairman has recognized this. We have been making important changes both structurally and operationally, and we have been preparing for basic changes in the way the industry functions.

As I go through my prepared remarks this morning, I would like to supplement the record with a couple of developments that have occurred since we filed our statement on Tuesday of this week which clarifies this view. We are hopeful that the Congress will continue to pursue the goal of developing legislative guidelines which have helped to shape the future of the industry, recognizing, as the gentlemen have said this morning, the need to continue the self-regulatory concept and expand it into one of cooperative regulation throughout the industry and the Government.

As requested, I will comment very briefly and interpolate through my prepared statement on the four questions which were raised in the chairman's letter to us of September 21.

The first of these questions deals with the possible reallocation of self-regulatory authority, to which the gentlemen before me have

spoken, and also to the question of the legal and operating relationships between the SEC and the exchanges. As you know, both of these questions are of crucial, long-range importance to the New York Stock Exchange. Our new board of directors has been in office only 3 months. As a matter of fact, they are holding their fifth meeting this afternoon, and as a result, have not yet had an adequate opportunity to focus on these issues and to formulate New York Stock Exchange policy in either of these areas.

I think it is pertinent to note, however, that as the securities industry approaches the goal of a central exchange system—a goal to which I believe all of us are committed—we will be in a better position to determine whether or not it may be desirable to make specific changes in the structure of the existing self-regulatory apparatus and in the existing relationships between the self-regulatory organizations and the SEC.

In any event, I want to assure the Subcommittee that we will be happy to supplement this statement with a clear statement of the exchange's views on both of these important issues as soon as our board has formulated its positions.

In this connection, I might just mention that on Tuesday of this week—that is to say, October 2—the chairman of the New York Stock Exchange, Mr. James J. Needham, announced the appointment of a committee of the Exchange to consider whether the Exchange should have guidelines for its membership regarding the sale of new issues of securities. At that time, Mr. Needham said, "If it is decided that the Exchange should expand its self-regulation into the new issues area, the committee would then develop appropriate guidelines for NYSE organizations to follow."

If I may, I would like to offer this release for the record since it points to an area that has been one traditionally handled by the NASD, and the New York Stock Exchange, in naming this committee, is responding to a request from Chairman Casey of the SEC that the Exchange consider developing guidelines for its membership to cover suitability standards in the new issues area. I might mention that this request from Chairman Casey was received in August. This matter was taken up with the New York Stock Exchange board on September 7, and this committee, as I say, was appointed on October 2, which gives some indication of the dispatch with which the exchange can deal with matters of this type.

Senator WILLIAMS. Thank you. I appreciate that.

Mr. CALVIN. May we offer that for the record?

Senator WILLIAMS. We will include that in the record.

(The press release follows:)

NEW YORK STOCK EXCHANGE, INC.,

NEWS BUREAU,

Tuesday, October 2, 1972.

NYSE PANEL TO CONSIDER NEW ISSUES GUIDELINES

James J. Needham, Chairman of the New York Stock Exchange, announced today the appointment of a committee to consider whether the Exchange should have guidelines for its membership regarding the sale of new issues of securities.

L. Emery Katzenbach, Chairman of the Board of White, Weld & Co., Incorporated, will be chairman of the group, which is being appointed to consider a request of the Securities and Exchange Commission.

Mr. Needham said "If it is decided that the Exchange should expand its self-regulation into the new issues area, the committee would then develop appropriate guidelines for NYSE member organizations to follow."

In almost all cases, the new issues on which the committee will focus are the shares of companies going public for the first time and are not listed on the Exchange; they are traded in the over-the-counter market, which is regulated by the National Association of Securities Dealers.

In August, Chairman Needham received a letter from Chairman William J. Casey of the SEC suggesting that the Exchange consider adopting guidelines for its membership that would cover suitability in the new issue area. Chairman Casey's request was discussed by the Exchange's Board of Directors at its September 7 meeting and Mr. Needham was authorized at that time to appoint a committee on suitability.

In his letter, Mr. Casey asked the Exchange to consider "the investment objectives, financial situation and needs of the customer as well as the customer's experience and sophistication in securities transaction."

The SEC Chairman also asked the Exchange to consider "the proper documentation necessary to assure compliance (by member organizations) with such suitability requirements."

Besides Mr. Katzenbach, the members of the five-man committee are: Donald C. Cook, Chairman of American Electric Power Corp. and a Director of the NYSE; Robert M. Gardiner, President of Reynolds Securities Inc.; Arthur J. Levine, Chairman of Weis, Voisin & Co., Inc.; Alexander Yearley, IV, Chairman of The Robinson-Humphrey Company, Inc. Mr. Needham will serve ex-officio.

The committee expects to begin its meetings shortly.

Mr. CALVIN. Turning to the next question, which deals with the governing boards of the self-regulatory organizations, the Subcommittee is, of course, aware that the NYSE earlier this year completed a precedent-shattering reorganization of its governing structure.

Our objective in restructuring the Exchange's policymaking body was twofold: to reflect the fact that the interests of the exchange are closely related to those of the public; and to provide for an increased concentration of leadership in the Exchange's governing structure. We believe that the recent reorganization fulfills that objective.

That reorganization of the Board stemmed from a report submitted to the Exchange in December 1971 by a special committee headed by Cornelius W. Owens, a public member of the previous board who has also been elected to the new board. That report was based on an earlier one by William McChesney Martin, Jr., in August 1971, which was made at the exchange's request.

The new board is composed of 10 industry directors, 10 public directors and a full-time salaried chairman who is also the Exchange's chief executive officer. The creation of the office of full-time chairman establishes a greater focus of responsibility than existed under the previous structure where leadership was shared by an unpaid chairman, elected from the Exchange membership and concerned primarily with policy matters, and a full-time salaried president chosen by the board as chief executive officer.

Attached to this statement, as exhibit A, is an article from the August 1972 issue of The Exchange magazine which includes brief biographical sketches of all 21 members of the new board of directors.

We believe that the Exchange is indeed fortunate to have been able to attract to the new Board the men and one lady of outstanding qualifications and caliber. In its first 3 months in office, this Board has demonstrated an extraordinary commitment and ability to grasp and deal constructively with the complex issues which have already come before it.

It is perhaps significant that the American Stock Exchange, as Mr. Kolton just said, has undertaken a similar major effort to reorganize its governing structure. Earlier this year, in an appearance before the House Subcommittee on Commerce and Finance, the president of the New York Stock Exchange, Mr. Robert W. Haack, and I commented at some length on the approach to a central exchange system. At that time, we stated—and I am quoting—“As an essential part of this approach * * * the other stock exchanges and the NASD should be reorganized along the same lines as the reorganization of the New York Stock Exchange, to broaden public representation on their governing boards.”

I think we all recognize that there are some special situations in the other organizations which need to be taken into account as the reorganizations are moved ahead.

I should add that Chairman Needham of the New York Stock Exchange and our new Board have recognized, as did the House Subcommittee on Commerce and Finance in its recent report, that the public directors may often be less familiar than industry directors with the background and details of many problems with which they will have to deal. If public directors are to make a meaningful contribution, they must be in a position to reach completely independent judgments based on a knowledge of all the facts concerning policy matters. To facilitate this, the Exchange has created a new full-time post of counsel to the board of directors, with responsibility for helping them to obtain material necessary to an objective evaluation of the policy questions which come before the board. The cost of providing this facility—including whatever supporting staff counsel to the board may require—is being borne by the Exchange. The counsel, Mr. Charles M. Mattingly, Jr., assumed his duties on Monday of this week and he will have whatever supporting staff that will be required. This staff will be, of course, independent of the rest of the staff at the New York Stock Exchange.

Senator WILLIAMS. I hate to interrupt, but what is his background?

Mr. CALVIN. He is a practicing attorney and most recently has been engaged in the general practice of law in a small community in New York. Prior to that time, he was engaged in a practice of law dealing primarily with corporate matters and is a man of broad experience. He is in his late 40's. He is a capable man, I think, in every way.

If the Chair would like, I could submit a statement of his background as included in the news release that was made at the time of his appointment.

Senator WILLIAMS. I would appreciate that. Excuse the interruption.

(The following information was received for the record:)

[New York Stock Exchange Press Release, Sept. 7, 1972]

COUNSEL NAMED TO ASSIST EXCHANGE BOARD MEMBERS

James J. Needham, Chairman of the New York Stock Exchange Inc., announced today the appointment of Charles M. Mattingly, Jr., to a newly created post of Counsel to the Board of Directors.

Mr. Mattingly's job, said Mr. Needham, will be to assist the 20 members of the Exchange's newly reorganized Board of Directors by obtaining information that will assist directors in evaluating the policy questions that come before

the Board. Mr. Mattingly will work on a full-time basis at the Exchange, with necessary supporting staff. It is anticipated that the 10 public directors will make the greatest use of the Counsel's office; however, his services will also be available to the 10 industry directors.

In announcing the appointment Mr. Needham said: "The Stock Exchange confronts a totally new situation in that half of its directors come from outside the securities industry. They were selected to represent the public point of view. In order to make their work on the Board more effective and in line with the recent recommendations of Congressman John Moss' Subcommittee, it is important that they be in a position to reach completely independent judgments based on a knowledge of all the facts concerning policy matters. With the services of Mr. Mattingly as Counsel to the Board, our Directors will be much more effective in carrying out their responsibilities to represent the public viewpoint."

Mr. Needham added that: "Of course, the extremely competent professional staff of the Exchange will be available to Mr. Mattingly to supply a great deal of the information he requires. However, Mr. Mattingly will have the right and the resources to go outside the Exchange whenever necessary to obtain information and viewpoints that he may require in the performance of his duties."

Mr. Needham said that his selection of Mr. Mattingly was influenced in large part by the fact that Mr. Mattingly's career embraces both the law and an extensive record of public service. Mr. Mattingly met with members of the Board of Directors today. He will start his new duties on October 1.

Mr. Mattingly, who is 48 years old, has been a practicing attorney in New York for 21 years. A graduate of Fordham College and Fordham Law School, he became a member of the New York Bar in 1950 and has been admitted to practice in the Tax Court of the United States, and by the U.S. Treasury Department, the Federal Maritime Commission and the Interstate Commerce Commission. He is a member of the firm of Mattingly and Cosgrove, Old Bethpage, New York and was formerly a member of the firm of Lorenz, Finn & Giardino, New York City.

Mr. Mattingly has long been active in civic and religious affairs on Long Island. He has served on the Board of Education of his home community of Plainview-Old Bethpage since 1956. He is also a member of the Commission for Ecumenism for the Diocese of Rockville Centre and a member of the Long Island Inter Faith Council.

During World War II, he served three years in the United States Army.

Mr. Mattingly is married, is the father of five children and has been a resident of Old Bethpage since 1955.

Mr. CALVIN. Also, I just might mention here that our new Board and Chairman recognize the in-Board public responsibilities and to assist in carrying out those responsibilities they are, among other things, planning to have meetings outside the city of New York. The first of those meetings will be held in Chicago in December. This will mark the first time that the Board of Governors or Directors of the New York Stock Exchange has held a policy meeting outside the city of New York. That will be on December 6 and 7.

Early next year, a similar meeting is planned to be held in the State of California and this will become a regular practice thereafter.

In addition to that, distinguished people who have expertise that can be of assistance to the board will be meeting with the board from time to time. Today, for example, Chairman Woodside, chairman of the Securities Investor Protection Corp., will be meeting with the Board of Directors. In a future meeting, one of the men on this panel, Mr. Gordon Macklin, will be similarly meeting with our Board of Directors. This is the type of thing which we plan to do on a regular basis in the future.

I might mention in that connection, as Mr. Macklin has, that moves are underway to expand the cooperation between the New York Stock Exchange and the other industry organizations, the NASD in particular. Discussions have been held, as Mr. Macklin has stated, with our

Chairman and we will continue to improve the areas of regulatory activity with greater cooperation which may facilitate our joint efforts.

Senator WILLIAMS. I am going to have to break and go over and vote again. Let me ask, Mr. Calvin, you mentioned a board meeting this afternoon—do you have to be up at that board meeting?

Mr. CALVIN. Yes, I do, sir.

Senator WILLIAMS. Well, we will be running later here than 1. You might have trouble making the 1 o'clock shuttle.

Mr. CALVIN. I am prepared to stay here as long as the Committee requires.

Senator WILLIAMS. Okay. Well, I will be back as soon as I can.

(Recess.)

Senator WILLIAMS. Mr. Calvin, had you made your last point?

Mr. CALVIN. No. I had one more point to cover, Mr. Chairman.

The final question asks for our comments on improving the methods of adopting rules and disciplinary procedures. In this connection, the New York Stock Exchange has totally revamped its disciplinary procedures. This began with staff recommendations which were made to our board in May of this year and were approved in principle by the board of governors of the New York Stock Exchange on May 22, and became effective in July of this year after these amendments were approved by a vote of the membership of the exchange.

These new procedures provide, as is summarized in my prepared statement, that an accused person—that is, a registered representative or allied member, et cetera—has his case heard by a panel of his or her peers. All accused persons now have the right to legal or other counsel. Following that panel hearing an opinion is issued by the panel and the right of appeal is provided to the Board of the Exchange.

As I say, this new procedure became effective on July 19 of this year. Since that time, eight hearings have been held before these independent panels and of these eight, four decisions have been issued. The remainder are in the decisionmaking process and 17 additional hearings are currently scheduled.

Again, Mr. Chairman, I think this demonstrates that the self-regulatory organizations can come to grips with key issues, act promptly on them, and come up with a fair resolution. In that latter connection, on Tuesday of this week, after we filed our prepared statement, the Federal District Court of New York issued an opinion in a case involving three former officers of a former member firm against the exchange. That case is entitled Sloan versus the New York Stock Exchange. The opinion by Judge Lasker bears, I think, precisely on some of the matters which are being discussed at this hearing today, and for that reason I would like to offer the opinion as an exhibit in the hearing record.

This case involved three former partners of a member firm who were seeking to enjoin the exchange from commencing disciplinary action against them in view of the fact that the exchange had previously brought a civil action against them and others in connection with a failure of the firm with which they were associated. There is some language in this opinion which is interesting. In the interest of time—I shall not summarize it now except to say that Judge Lasker in his opinion has some very favorable things to say about these new exchange disciplinary procedures, saying, in effect, at one point, that

they are "the classic model for determination of litigated matters by an administrative agency." That is referring to the New York Stock Exchange's new disciplinary procedures. He comments favorably on this panel concept and in his decision dismisses the action for an injunction, saying that there is no violation of the constitutional rights of these plaintiffs, among other things.

As I say, I think this would be a worthwhile exhibit for these hearings.

Senator WILLIAMS. We would be glad to have that in the record. Thank you.

(The information follows:)

U.S. DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

72 Civ. 1765

JOHN J. VILLANI AND DONALD EUCKER, PLAINTIFFS,

vs.

NEW YORK STOCK EXCHANGE, INC., DEFENDANT

U.S. DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

72 Civ. 1516

FERGUS M. SLOAN, Jr., PLAINTIFF,

vs.

NEW YORK STOCK EXCHANGE, INC., DEFENDANT

APPEARANCES

Kraft & Hughes, Esqs., Gateway I, Newark, N.J. 07102, attorneys for plaintiffs John J. Villani and Donald Eucker.

Milbank, Tweed, Hadley & McCloy, Esqs., 1 Chase Manhattan Plaza, New York, N.Y., attorneys for defendant.

Olwine, Connelly, Chase O'Donnell & Weyher, Esqs., 299 Park Avenue, New York, N.Y., 10017, attorney for plaintiff Fergus M. Sloan, Jr.

LASKER, District Judge.

In these two related actions plaintiffs Eucker, Villani and Sloan move for preliminary injunctions to restrain the New York Stock Exchange ("Exchange") from proceeding with disciplinary hearings against them for alleged violations of certain rules and regulations of the Exchange and the federal securities laws.

The facts underlying the contentions of both sets of plaintiffs are substantially similar. However, while both sets advance common grounds for the preliminary injunctions, each presses grounds peculiar to it. In both actions, plaintiffs seek injunctions prohibiting defendants from holding alleged unfair and impartial hearings, as required by the Rules of the Exchange, the Securities Exchange Act of 1934 ("the Act") and the due process clause of the Fifth Amendment¹ on the grounds that 1) under the Exchange rules they will not be permitted to be

¹It is now beyond dispute that the Fifth Amendment due process requirements as to federal action apply to the disciplinary hearings conducted by the Exchange. Such hearings are conducted under the self-regulatory power conferred upon it by a federal agency, the Securities & Exchange Commission. In *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963), the court stated that the Exchange Act of 1934 imposed upon the Exchange the requirement that it comply with traditional notions of "fair procedures," at p. 364. See *Intercontinental Indus., Inc. v. American Stock Exchange*, 452 F. 2d 935 (5th Cir. 1971) where, in connection with a delisting of stock, the court held that the American Stock Exchange was subject to the requirements of the due process clause of the Fifth Amendment.

represented by legal counsel at the hearings; and 2) since the Exchange has instituted a separate civil action in this court against them and the other former partners of Orvis Bros. & Co. ("Orvis") based on the same charges as those brought in the disciplinary proceeding, it cannot render an impartial judgment as to those charges. Furthermore, Sloan contends that the procedures are unfair because the Exchange refuses to allow him to inspect all documents relating to his case in the Exchange's possession.

Eucker and Villani further ask for an order enjoining the Exchange 1) from failing to approve their applications to take responsible managerial positions with other member firms; and 2) from failing to permit Orvis' assets to be used to pay attorney's fees for the defense of the former partners.

FACTS

Until 1970 Villani, Eucker and Sloan were partners in Orvis, a member firm of the Exchange. Beginning in 1969 Orvis began to suffer severe financial losses so that in June of 1970 the Exchange, by virtue of its authority under the Act, ordered the firm's liquidation.

After determining that Orvis was running a deficit of five million dollars, the Exchange, pursuant to a liquidation agreement signed by the partners of Orvis, including plaintiffs, paid out that sum to the public customers of Orvis from its Special Trust Fund.

The Exchange then began an investigation into the Orvis collapse, which culminated in charges being brought by the Exchange against the partners of Orvis. The plaintiffs formally answered the charges, denying any wrongdoing, and requested a formal hearing, permission to be represented by counsel, and the opportunity to inspect all documents in the Exchange's possession relating to their cases.

The Exchange advised the plaintiffs that they would be permitted to have counsel present in the hearing room but that pursuant to Section 1 (d) of Article 5 of its constitution, counsel would not be allowed to address the hearing panel or examine witnesses. The Exchange refused to open its files to plaintiffs, but consented to make available specifically identified documents. According to Sloan's counsel a representative of the Exchange stated that the Exchange would use against Sloan only those documents of which it had sent him copies.

October 5th, 1971, a week after the charges were brought against the plaintiffs, the Exchange instituted a civil action in this court, *New York Stock Exchange v. Sloan, et al.*, 71 Civ. 2913, to recover from all the Orvis partners, as well as its accounting firm, the five million dollars that the Exchange had paid out from the Special Trust Fund. The claims in the civil suit are substantially identical to the charges specified in the disciplinary actions. Various partners of Orvis, including Sloan, have asserted counterclaims in the civil suit, contending that it was the Exchange, and not the partners, which actually caused the damages complained of.

After leaving Orvis, Villani and Sloan were employed as registered representatives with other member firms. The Exchange approved their applications "conditionally" pending the resolution of the disciplinary charges. On its own accord, one of the firms determined to terminate Sloan's employment while the charges were pending. Neither Sloan nor Eucker is presently employed by a member firm.

Since the filing of these motions, on May 18th, 1972, counsel for the Exchange, Milbank, Tweed, Hadley & McCloy, has informed the court by letter that the Board of Governors of the Exchange approved various recommendations to change the hearing procedures in disciplinary proceedings conducted by the Exchange. On September 5th, 1972, counsel for the Exchange further informed the court that the membership of the Exchange as well as the SEC had approved the proposals.

Section 23, Article XIV of the constitutional amendment, which abolishes the so-called "no-counsel rule," reads:

A person, firm or corporation shall have the right to be represented by legal or other counsel in any hearing and review thereof held pursuant to the provisions of this Article and in any investigation before any committee, officer or employee of the Exchange authorized by the Board of Directors.

Another significant amendment to the Exchange's procedures is the establishment of a Hearing Panel of three persons—to be composed of two fellow members (and allied members), who are not members of the Board of Directors, and headed by a Hearing Officer. The Hearing Officer is to be a member of the staff of the Exchange. He will act as Chairman of the Panel, and will have no other

Exchange duties relating to investigation or preparation of disciplinary matters. The panel will decide the case before it by vote of the majority, and will assess a penalty, if any. Either the Department bringing the charges or the accused may appeal an adverse determination to the Board of Directors. The Board may delegate the hearing of the appeal to a committee of its members for recommendation to the full Board.

Under the procedures in existence at the time the motions were filed, the accused would have been "tried" before a panel of three members of the staff of the Department of the Exchange which instituted the charges. That panel determined the accused's guilt or innocence and, if the determination was guilty, the Department bringing the charges imposed the penalty. Appeals, permitted to be taken only by the accused, were heard by the Advisory Committee of the Board of Governors, which committee then made its recommendation for Board action in the appeal.

By letter dated May 18th, 1972, counsel for Sloan stated that in his view the then proposed amendments do not dispose of the constitutional questions raised by Sloan's motion. First, counsel argued that, assuming the first two members of the proposed Hearing Panel can be impartial, the fact that the Chairman of the Panel would be an exchange employee would deny plaintiff his rights under the Fifth Amendment. Second, counsel pointed out that the right of appeal to the Board of Directors—the individual plaintiffs in the civil actions—leaves the situation substantially unchanged.

DISCUSSION

1. RIGHT TO COUNSEL

Since counsel for the Exchange has represented² that Section 23, abolishing the "no-counsel rule", would apply retroactively so that the hearings on the charges against the plaintiffs will be conducted under the revised procedures, this sector of the motion is rendered moot.

2. HEARING PROCEDURES

The amendments with respect to the make-up of the hearing panel appear sufficient to defeat the constitutional objections raised to the initial hearing procedure.

In the administrative process it is the norm for the agency to act both as accuser and trier; such a mixed function does not constitute a denial of due process. See *Intercontinental Indus., Inc. v. American Stock Exchange*, 452 F. 2d 935 (5th Cir. 1971), where, on a petition for review to the Fifth Circuit of an order of the S.E.C. granting the American Stock Exchange the right to delist the common stock of a corporation, the court held there was no denial of due process when a committee of the exchange first conducted an investigative hearing and then sat with the Board of Governors of the exchange while the entire Board considered the delisting application. The new exchange procedures relevant here provide that the members of the Hearing Panel shall be different persons and perform a different function from that of the personnel who investigate and institute disciplinary hearings, and provides that they shall not be Directors of the Exchange (the plaintiffs in the civil suit.)³ Such a bifurcation of authority is the classic model for determination of litigated matters by an administrative agency.

As we conclude that a panel so constituted can be presumed to be impartial with regard to matters arising internally within the Exchange, so we conclude that the same group can be presumed not to be prejudiced against the plaintiff merely because the Exchange has instituted a suit against them in this court. Where the relief requested is extraordinary—the grant of a preliminary injunction—such a presumption of regularity should be swept aside only by the presentation of persuasive evidence of personal, actual bias. Stated otherwise, the litigant must demonstrate that the Panel has "in some measure adjudged the facts as well as the law of [the case] in advance of hearing of it." *Gilligan, Will & Co. v. S.E.C.*, 267 F. 2d 461 at 469 (2nd Cir.) *cert. denied*, 361 U.S. 816 (1959). The fact that the

² Letter of Isaac Shapiro, dated May 18th, 1972.

³ Although it is true that the Chairman of the Board of the Exchange, subject to the approval of the Board of Directors, appoints the Hearing Panel, who serve at the pleasure of the Board of Directors, such fact alone is not a sufficient factual showing of probable bias or prejudice, as to justify the extraordinary relief of a preliminary injunction.

Board of Directors, now a separate functioning body from the Hearing Panel, has instituted civil litigation against persons who will appear before the Hearing Panel does not overcome this presumption. See *Federal Trade Commission v. Cement Institute*, 333 U.S. 683 at 702-703, (1948). There the court held that, even assuming that the entire membership of the FTC, as a result of prior official investigations, had expressed strong opinions before congressional committees that the defendants were in violation of the Sherman Act, such action did not constitute sufficient bias to disqualify the commission.

Furthermore, under plaintiffs' reasoning the Exchange is required to choose either between suing civilly in this court to recoup its losses or conducting disciplinary hearings. The congressional mandate of self-regulation by the Exchange embodied in the Exchange Act of 1934,⁴ would be frustrated by imposing such a dilemma on the Exchange. To carry out that mandate the Exchange is required by the Act to provide rules and take action, where appropriate for disciplining its members. The plaintiffs argue that the Exchange cannot exercise these disciplinary powers if it simultaneously sues them in court. However, there is no statutory or other authority which thus limits the Exchange's rights, and it cannot be required to forfeit its right to sue as the price for carrying out its obligations to discipline its members for the protection of the public.⁵

3. APPEAL PROCEDURE

We make no determination as to the fairness of the appellate procedures of the Exchange because we believe that the question is premature at this time. While it is true that appeals are to be heard by the Board of Directors (or a delegated committee of the Board) who are presently suing the plaintiffs here, and that, therefore, the question of fairness is more acutely presented than in the case of the hearing procedure, we think that until the hearing stage is completed, it is too early to consider appellate questions.

Although the plaintiffs assert that, at the hearing they will face a "kangaroo court", we have indicated our doubts that this is so, and it is mere speculation to predict the outcome of the hearing. Indeed two other Orvis partners have already been exonerated on the charges brought against them (Nelson Aff. Para. 18). The plaintiffs here may also be exonerated. While the new rules would permit the Exchange to appeal from such a finding, it is certainly possible that the Exchange would not press an appeal. We do not believe that a federal court should require an institution with such important public responsibilities as the Exchange to alter its rules against the mere possibility that some unfairness might some day occur. We agree with the views expressed by Judge Motley in *Jacobson v. American Stock Exchange*, CCH Fed. Sec. L. Rep., § 93,131 (S.D. N.Y. 1971), that:

... a judicial test of the no counsel provision is both premature and novel, thereby precluding an exercise of this court's discretion to grant a preliminary injunction as requested;

and Judge MacMahon in *Crimminis v. American Stock Exchange*, 72 Civ. 290, July 26th, 1972, that:

Until the hearing before the board is concluded, it is sheer speculation for plaintiff to predict the outcome of it and to suggest reasons for that outcome. What plaintiff urges as immediate injury are his speculations that he might be found guilty because he was not represented by counsel and that, if so, he might suffer economic loss or criminal prosecution. We think this is too tenuous a string of possibilities to serve as a basis for a preliminary injunction.

Finally as to both hearing and appeal, there is a serious question here as to whether the plaintiffs consented to the procedures of which they complain. In their respective applications to become members of the Exchange, the plaintiffs represented and pledged under oath that they would be bound by the constitution and rules of the Board of Directors of the Exchange, and any amendments

⁴ § 19(b) of the Act, 15 U.S.C. § 783(b); *Silver v. New York Stock Exchange*, 373 U.S., 341 at 352 (1963).

⁵ In a reply memorandum, Villani and Eucker suggest for the first time in this suit, that the court grant a permanent injunction and permit the Exchange to amend its complaint to seek "disbarment" relief against the plaintiffs in this court, or in the S.E.C. so as to overcome the alleged dilemma. Putting aside the question whether a reply memorandum is the appropriate place to seek to amend the grounds for an injunction, neither this court nor the S.E.C. has power to conduct proceedings for the expulsion of Exchange members when Congress has specifically delegated that authority to the Exchange.

thereto. Since plaintiffs are sophisticated businessmen and since, in order to be approved by the Exchange, they were required to pass an examination based in part upon the Exchange's constitution and rules, there is no doubt here that their consent to the disciplinary procedures was given knowingly and intelligently. See *Cocnen v. R. W. Pressprich & Co.*, CCH. Fed. Sec. L. Rep. § 93, 335 (2d Cir. 1971). Were the recent procedures more suspect from a constitutional viewpoint, we might be inclined to give less weight to this argument. However, as stated above, at least insofar as the hearing stage is concerned, we find that they are constitutionally valid.⁶

4. "DISCOVERY" PROCEDURE

We think that Sloan (as well as Villani and Eucker) are entitled to inspect all documents within the Exchange's possession relating to their respective cases. Should these include documents of a confidential or privileged nature, the Exchange is, of course, free to apply for a modifying order. It seems reasonable to view the Federal Rules of Civil Procedure as a model of procedural due process. In ordinary civil litigation, the plaintiff would be entitled to the material he seeks under Rule 37. Since his stake in the instant proceedings is as substantial as it would be in civil litigation, we believe that the pattern of the Rules should be followed.

Sloan correctly points out that the Exchange's position that it will only use against the plaintiffs those documents of which he has been sent copies, ignores the possibility that there may be documents which Sloan may find helpful to his case or which have been overlooked by the Exchange. Furthermore, to require a plaintiff to identify the documents he wishes to use when he does not even know what documents are in the possession of the Exchange, places him in an impossible cul-de-sac. It is significant that nowhere in the voluminous papers submitted by the Exchange does it advance a practical or legal rationale for its position.

5. DEMAND THAT THE EXCHANGE APPROVE PLAINTIFFS' APPOINTMENT TO MANAGERIAL POSTS

Villani's and Eucker's request that the Exchange presently approve their applications for approval to serve in certain managerial positions is denied. A motion for a preliminary injunction is addressed to the discretion of the court, which balances the possible injuries and conveniences of the parties as they would be affected by the denial or granting of the relief, *Yakus v. United States*, 321 U.S. 414, 440 (1944). Where a public interest is involved, as it is here because the Exchange is charged by the Exchange Act with the responsibility of protecting public investors,⁷ a court should go much further both to give and withhold relief in furtherance of the public interest than they are accustomed to do when only private interests are involved" *Yakus v. United States*, supra, at 440-441. While there is no question that by our denial plaintiffs will continue to suffer harm, both financially and to their reputation, the public has an overriding right to protection until it is determined whether the plaintiffs have acted culpably. In making this determination, however, we do not intimate any view as to the merits of the charges.

Moreover, the plaintiffs have not altogether been foreclosed from pursuing their profession, for the Exchange has permitted them to be engaged by member firms as registered representatives under a conditional approval. In view of the serious nature of the charges and the important public responsibilities imposed by law on the Exchange, it cannot reasonably be required to do more.

⁶ Sloan also contends that the disciplinary hearings are a group refusal to deal or boycott in violation of Section 1 of the Sherman Act. In *Silver v. New York Stock Exchange*, 373 U.S. 341 at 357 (1963), the Court stated that Exchange actions, which might otherwise be illegal, are exempt from the antitrust laws when "necessary to make the Exchange Act work." For the Exchange to regulate the activities of its members it must have the power to expel, suspend, or discipline, as Section 6(b) of the Act specifically requires. Of course, as *Silver* instructs, such actions can only be taken when the procedures used are "fair". *Silver v. New York Stock Exchange*, supra, at 364. However, concluding as we have that the procedures complained of are fair, plaintiffs' antitrust claim must be denied. See also *Cowen v. New York Stock Exchange*, 371 F.2d 661 (2d Cir. 1967).

⁷ Securities Exchange Act of 1934, Section 19(d).

6. ATTORNEYS FEES

Eucker's and Villani's request that the Liquidator pay the attorney's fees incurred in their defense of the Exchange's civil action is denied. Such a request is directly contrary to the terms of the liquidation agreement,⁸ signed by all the plaintiffs, pursuant to which Orvis was liquidated. It provides *inter alia* that (a) before payment is made on any claim of the signatories, the Trustees of the Special Trust Fund shall be repaid for amounts expended to assist the customers of Orvis; (b) the Liquidator to whose care all assets of Orvis were transferred shall act in accordance with what he deems to be good business practices; and (c) no signatory shall have any right of recourse against the Exchange or the Trustees. Under the terms of the agreement, plaintiffs are estopped from claiming attorney's fees from Orvis' assets until either the Liquidator exercises his discretion or the monies have been repaid. Since he is a sophisticated businessman, we cannot accept as legally sufficient Villani's explanation that "I do not remember the terms of that document, because I did not read it before signing it." Villani Aff. Par. 20.

Without intimating any view as to the viability of their rights to use these assets, the motion is denied without prejudice to such rights as the plaintiffs may have, if any, in the event of a conclusion of the litigation favorable to them.⁹

To recapitulate, (1) plaintiffs' motions to enjoin the Exchange from conducting disciplinary hearings because they will not be allowed to be represented by counsel is denied as moot; (2) plaintiffs' motion to enjoin the Exchange from holding the proposed hearings on the grounds that the tribunal will not be impartial is denied; (3) plaintiff Sloan's request for an order allowing him to inspect all documents relating to his case is granted. The order shall likewise apply to plaintiffs Eucker and Villani, and is granted without prejudice to the Exchange to move in this court for a modifying order in the nature of a protective order; (4) plaintiffs Eucker's and Villani's requests for an order enjoining the Exchange from failing to approve their application to take managerial positions with other member firms and for an order enjoining the Exchange from failing to permit Orvis' assets to be used to pay attorney's fees are denied. Villani's and Eucker's motion to add William Raguson, Liquidator of Orvis, as a defendant is granted.

The foregoing constitutes the court's findings of fact and conclusions of law pursuant to Rule 65, Fed. R. Civ. P.

Submit order on notice.

Dated: New York, N.Y., October 2nd, 1972.

U.S. District Judge.

Mr. CALVIN. Moving on just briefly, again at my last appearance before this Committee, I made reference to the fact that Mr. Haack, former president of the Exchange, and I had suggested to the House Committee that there be more public participation in the rulemaking procedures of the Exchange, and since that time the House Committee has endorsed that view in its report.

Also, our new Board Chairman, Mr. Needham, has inaugurated a practice of personally briefing representatives of the news media immediately following meetings of our board of directors. Such a briefing will be held probably this afternoon following the board meeting today, for example. At the same time, we are issuing to the press now releases of the action taken by the board at the meeting that same day. Also, in view of the great public orientation of this Board, their

⁸ See Exhibit O to Nelson Aff.

⁹ On September 1st, 1972, Villani and Eucker moved pursuant to Rule 15(a), Fed. R. Civ. Pr. to amend the complaint by adding William J. Raguson, Liquidator of Orvis, as a party defendant so that, should plaintiffs prevail on this sector of the motion, the assets of Orvis could be made available to them to pay attorney's fees. The Exchange opposed the motion on the ground that the relief requested was so without merit that leave to amend should not be granted. Since leave to amend should ordinarily freely be given under Rule 15(a), Fed. R. Civ. Pr., and since the Exchange has not demonstrated that it will be prejudiced in any way, the motion is granted.

obvious interest to expand public participation in all phases of the exchange activity, I think even greater strides will be made in this area in the future.

Again, I want to say, as I have said before, that we think that the continuing relationship between self-regulatory organizations, the Congress and the SEC is obviously in the public interest, and those things that can be done to strengthen that relationship are equally in the public interest, and I thank you.

(The full statement of Mr. Calvin may be found at p. 298.)

Senator WILLIAMS. Thank you very much, Mr. Calvin.

Mr. Thomas Phelan, of the Pacific Coast Exchange.

STATEMENT OF THOMAS PHELAN, PRESIDENT, PACIFIC COAST STOCK EXCHANGE

Mr. PHELAN. Thank you.

On behalf of the Pacific Coast Stock Exchange, I am pleased to have this opportunity to testify before your Subcommittee. Because of the relatively short notice concerning this hearing, I was not able to ascertain the views of the Board of the Pacific Coast Stock Exchange concerning the issues under consideration here. My statements today, therefore, should not be understood as necessarily stating the views of the board of the Pacific Coast Stock Exchange, but I believe that they would support them.

My association with a self-regulatory agency in the securities industry dates back more than 40 years to the era before the Exchange Act when self-regulation was the only form of regulation. I have had an opportunity to witness the development of self-regulation and the development of the role of the Securities and Exchange Commission as regulator of the self-regulators. In general, the self-regulatory scheme of the Exchange Act has worked quite well. The United States has a capital market second to none in the world. Public confidence in this market, and public participation, is much greater than in any other major country.

Some recent events have, however, suggested deficiencies in this regulatory scheme. Important developments such as development of a central market system and development of a national system of securities depositories have been hampered by rivalries between self-regulatory agencies. In some areas of their operations, self-regulatory agencies are uncertain of their ability to regulate because of threats of antitrust liability. The self-regulatory agencies have played a vitally important role in the American system of securities regulation. If they are to continue playing this role in the future, however, the two problems mentioned above must be resolved. Methods will have to be developed to improve cooperation between self-regulatory agencies, and the antitrust responsibilities and exposure of self-regulatory agencies will have to be better defined.

Having made these general comments, I would now like to comment specifically on the questions proposed by the Subcommittee.

The first is the question of reallocating authority among the self-regulatory agencies. Currently, there are wide areas of overlap between the regulatory authority exercised by the various self-regulatory bodies. In practice, however, the self-regulatory bodies have achieved

a large measure of agreement about who regulates whom and who regulates what. Jurisdictional disputes still arise, but they generally are resolved without serious inefficiency and without any loss in regulatory effectiveness.

I do not see a need for new legislation defining the jurisdiction of the self-regulatory bodies. Legislation would freeze patterns of regulatory responsibility. The present system has the advantage of flexibility in that it allows a self-regulatory body, such as the Pacific Coast Stock Exchange, to leave primary regulatory responsibility over a member to a larger exchange to which such firm belongs, while retaining the power to assume jurisdiction if this is necessary. An exchange, or other self-regulatory body, has a responsibility to protect itself, its clearing corporation, and its members, from losses occasioned by the economic instability, or improper conduct, of a member. Unless a self-regulatory body has jurisdiction over the conduct of all of its members, it cannot fulfill this responsibility.

About the question about the composition of the governing boards of self-regulatory agencies, the governing boards of self-regulatory agencies should be, first of all, representative of the agency's membership. The board should not be dominated by any particular set of interests, such as the floor. It is for this reason that the Pacific Coast Stock Exchange has the rule that two of the three governors elected each year must be "office members or office allied members of the exchange."

The extent to which the governing boards of self-regulatory agencies should be representative of the public raises a much more difficult question. And the answer to this question may differ if we are talking about the board of a primary market, such as the New York Stock Exchange, or if we are talking about the board of a regionally oriented exchange, such as the Pacific Coast Stock Exchange. Since the New York Stock Exchange has greater public impact than the Pacific Coast Stock Exchange, the arguments for public representation on the board of the New York Stock Exchange may be greater.

On a broader plane, I have lingering doubts about the benefits of public representation, at least as it has been conceived to date. It seems to me that the public is not really being represented on a board unless it has chosen its representatives. There is no necessary reason why the chairman of a large listed company is any more representative of the public, or of the investing public, than an officer of a member firm which does a large retail securities business. The opposite may well be true. An officer of a member firm doing a retail business has substantial contact with the investing public and substantial reasons to be sensitive to the needs of the investing public. An officer of a member firm also will be knowledgeable about industry problems. Board members from outside the securities industry would have to devote substantial time and effort to educating themselves in order to contribute meaningfully to board decisions. Public representation may thus be merely cosmetic, without any real effect on the responsiveness of such boards to the public.

Historically in this country, we have expected members of the governing boards of the self-regulatory agencies to be men who are able to take a broad view of industry problems and who are sensitive to protecting the public interest. We have not, however, expected them to be representative of the public. To represent the public, and to

ultimately protect its interests, we have relied upon continuing inputs from Congress, which is representative in a real sense, and upon continuing supervision from the Securities and Exchange Commission, which is required to be responsive to the public interest because it is responsible to Congress. All the recent discussion about public memberships on the boards of the self-regulatory agencies has not yet convinced me that there is anything to be gained by departing from this historical pattern.

PROCEDURES FOLLOWED BY SELF-REGULATORY AGENCIES IN ADOPTING RULES AND POLICIES

Today, as we are moving toward a central market system, and toward a national system of securities depositories, actions taken by one self-regulatory agency increasingly have substantial effects on other self-regulatory agencies. For this reason, I propose that whenever a self-regulatory agency files a rule or policy change with the Securities and Exchange Commission, it should be required contemporaneously to mail the proposed change to all other self-regulatory bodies. Rules which are concerned solely with internal management might be exempted from this requirement. Such a provision, which should be added to H.R. 15303, would give other self-regulatory agencies a chance to comment on the proposed changes before the Commission allows them to become effective.

Now, as to the proposals contained in H.R. 15303, the Securities and Exchange Commission has the responsibility for protecting the health of the Nation's securities markets. It has to have adequate statutory authority to fulfill this responsibility. H.R. 15303, proposed by the Commission, would give the Commission additional power which it believes is needed. With respect to exchanges, the Commission would gain the power to take disciplinary action against a member or person associated with a member if such person violates an exchange rule. The Commission would also be given the power to review the disciplinary proceedings of exchanges. Finally, the Commission's power under section 19(b) of the Exchange Act would be expanded and its procedural freedom increased. I see nothing to oppose in the first two proposals. Discipline often involves questions affecting the public interest, and it is appropriate that the Commission receive greater power to intervene in this area.

I find the third proposal, involving an amendment to section 19(b), generally acceptable, but I have reservations about the procedural effects of this amendment. I do not object to the idea that the Commission should no longer be limited, in its substantive power, to the items enumerated in section 19(b), plus "similar matters." I do see some problems with exempting the Commission from formal rule-making without specifying a satisfactory procedural substitute.

Under section 19(b) as it now stands, there are substantial doubts about the Commission's power to act except by formal proceedings in which evidence is submitted orally, testimony is subject to cross-examination, and the decision must be based upon a record. I believe that this procedure is too cumbersome to allow the Commission to meet its broad responsibilities. The language proposed in H.R. 15303,

however, would go too far in the opposite direction. For example, the Commission is proposing that it be exempted from the requirement that when a hearing is held, the rule cannot be finally adopted until the hearing is completed. An opportunity for hearing, afforded after a rule has been adopted, is an illusory right. This provision should be modified so that only in cases of emergency could the Commission adopt a rule before completion of a hearing. In such cases, the Commission should be required to state the nature of the emergency, and the reason that it is essential for action to be taken prior to a hearing.

I believe it is possible to devise a middle course which does not hamstring the Commission as formal rulemaking does, but which gives interested parties sufficient procedural rights to insure that their views are considered by the Commission.

In our statement, we have made some suggested changes in this regard. With these modifications, I believe the Commission's proposed amendment to section 19(b) can represent a substantial improvement over the present statute.

I have enjoyed this opportunity to appear before you on behalf of the Pacific Coast Stock Exchange. I hope that my remarks will assist the Subcommittee in its important work. Thank you very much.

(The full statement of Mr. Phelan may be found at p. 311).

Senator WILLIAMS. They certainly will. We appreciate your being here again, Mr. Phelan.

Now, finally, for our formal statements, Mr. Wetherill from Philadelphia.

STATEMENT OF ELKINS WETHERILL, PRESIDENT, PBW STOCK EXCHANGE

MR. WETHERILL. We appreciate the opportunity to appear here at this hearing and to give our thoughts on the important questions that were raised by the Chairman.

As to the first question, on the reallocation of authority among the various self-regulatory agencies, the PBW Stock Exchange strongly favors the self-regulatory process as promulgated under Federal securities laws. Within this context, the PBW feels that a cooperative relationship should exist between the various regulatory agencies while for the future we favor autonomy within the system.

This cooperation between regulatory agencies presently manifests itself in the cooperative enforcement program already in effect. The program itself, while very effective, also fosters a sound basis for understanding and appreciation of the many problems and difficulties which arise in the regulatory process as they relate to the respective regulatory areas of the participants. The PBW, therefore, feels that greater emphasis should be placed on this program with a view toward expanding the scope of the program now in effect.

Greater emphasis and expansion of the cooperative enforcement program should encourage the various regulatory agencies to strive for specific areas of agreement as to the activities over which each agency should exercise authority. We feel the areas for potential agreement should include but not be limited to: (a) broker-dealer inspections; (b) broker-dealer reporting; (c) sales practices; (d) recordkeeping requirements and uniform interpretive policies.

Within this framework the Securities and Exchange Commission would continue to have oversight responsibilities for the activities of the various self-regulatory agencies.

The second question, the composition and manner of selection of governing bodies of the self-regulatory agencies, we believe at the present time each of the self-regulatory organizations should be able to determine the applicable rules applying to the composition and manner of selecting members of their boards. Present supervision by the Commission and judicial review is adequate to insure due process.

It is quite possible the boards of self-regulatory bodies will need to be changed in response to the changes in the structure of the Nation's securities markets. Market structure changes will probably require representation by public investors and companies whose securities are traded on the boards. However, because of the complexity of problems to be considered, we believe that governing boards should be composed primarily of industry members.

The governance of separate marketmaking centers should be a full-time responsibility for at least some of the key personnel responsible for day-to-day operations. Accordingly, the marketmaking centers or self-regulatory agencies should have adequate professional staffs which enjoy a degree of autonomy.

The PBW does not believe that any Congressional or Commission action is required at the present time to alter the structure of the boards of existing self-regulatory organizations. We do not believe Government action is necessary because competitive forces should create economic pressures to make the boards of the separate markets more responsive to the needs of the investing public.

Question 3, procedures of self-regulatory agencies in adopting rules and policies and conducting disciplinary proceedings.

The Exchange Act now charges such agencies as being affected with a public interest, vests them with quasi-governmental power, and subjects them to oversight by the SEC which may grant or withhold an exchange's registration in accordance with statutory standards of conduct, referring inter alia, to enforcement capability, performance, and fair administration of exchanges. SEC rule 17a-8 requires advance notice to the Commission of proposed rule changes by exchanges. The present law appears to us to be adequate in terms of residual Federal power, standards, and sanctions.

Improvement in procedures should be concerned with professionalism, objectivity, staff capability, due process, and possible conflicts with other areas of the law such as antitrust.

A professional approach by board and committee members and by staff should be encouraged and required. In the long run, self-interest and the public interest interact to serve each other. If they cannot do so, present legislative sanctions can be invoked in favor of the public. Rule-making should allow for adequate notice to a membership with varied spectrums of interest. Using such procedure initially, the other guidelines, objectivity and procedural due process, can be more readily achieved. Present reporting requirements under the Exchange Act provide adequate notice to the SEC.

The procedure in and conduct of disciplinary proceedings similarly require due process, objectivity, and professionalism. Appellate remedies are available in Federal and State courts. An aggrieved party can

now complain to the SEC for failure of an exchange to follow its rules or fairly administer its affairs.

Attainment of all of the foregoing objectives can be facilitated by the upgrading of the competence and responsibilities of professional staff personnel. Formal delegation of authority by governing boards becomes part of the rules and policies of an exchange for which there is legal responsibility for enforcement.

Conflicts between the statutory scheme of self-regulation and the antitrust laws are both real and potential. Self-regulatory procedures conceptually imply certain types of concerted action which should be protected.

There is considerable uncertainty regarding the extent of implied antitrust immunity, which has evolved to date through judicial opinions, for actions complying with self-regulatory requirements. We believe that Congress should act to balance competing interest—the need for self-regulatory authority within appropriate limits, and the need for reasonably certain guidelines to insulate concerted actions against antitrust liability to the extent that the public interest requires.

Extremely complex issues are inherent in determining the precise extent to which antitrust immunity should be granted. We are not prepared, at this time, to propose specific legislation for this purpose.

Present self-regulatory procedures have worked. They can, of course, work better. Their foundation and structure are worth preserving and encouraging. Direct governmental participation should be held to a minimum to encourage decentralization, flexibility and initiative. Indicated improvement should first be sought through more vigorous enforcement and use of the present statutory scheme and common law guidelines.

Appropriate legal and operational relationships between regulatory agencies and the SEC.

The appropriate legal relationship between the self-regulatory authorities in economic areas should be one of competition, rather than regulation. The PBW has attempted to provide competition between marketplaces by providing membership to all registered broker-dealers who meet capital and competency requirements; providing competition between specialists and third marketmakers on our floor; and displaying the quotations of our marketmakers in the NASDAQ and AuTex systems.

We support the concept of a central market system. However, we envision the central market consisting of legal separation of market-making centers each being autonomously regulated. All markets should be linked electronically and thus brought into competition, and all trades reported on a composite tape.

We believe there are no legal or possible operational relationships which required each center to have uniform, or what has been termed "equal regulation." Uniform rules are unnecessary, provided that certain minimum requirements are imposed throughout the industry to insure an appropriate level of professional competence.

No market center should be relieved of the pressure of competition from other marketplaces, especially in the near term future when the entire market structure can be expected to evolve rapidly in response to both legal and technological developments. So long as each marketplace meets or exceeds minimum standards, the freedom of each to

tailor its own rules should not be restricted by a need to conform to the rules of any other marketplace.

If a particular practice is considered to be unfair competition, that practice should be dealt with directly. However, whatever justification there may be to eliminate particular unfair competitive practices, there is no justification whatsoever for eliminating all diversity by imposing a uniform set of rules on all competitors.

We believe, as discussed in section I of this memorandum, that the operational relationships in the area of competitive regulation and supervision of members should be expanded.

Clearance and the processing of securities are key areas for the development of operational relationships between regulatory agencies. This Subcommittee has considered much testimony in this area and has recommended certain legislative solutions. We have submitted our views and recommendations, and it is not necessary to reiterate them in detail. We generally support steps which will create operational efficiency between members and other regulatory agencies.

This Exchange does not favor the adoption of H.R. 15303. House bill H.R. 15303, in part, amends section 19(b) and confers upon the Commission new authority with regard to the adoption, amendment, alteration, or rescission of rules of self-regulatory organizations. The proposed section 19(b) provides the Commission with the broadest of powers in the rulemaking area with limited recourse by an exchange to question the action by the Commission. One must immediately question the necessity of dramatically increasing the powers of the Commission. Such an increase in power would severely limit the concept of self or cooperative regulation.

This bill would eliminate the valuable contributions made by existing exchanges in the area of regulation and innovation. When Congress was considering the adoption of the Securities Exchange Act of 1934 it realized that the concept of self-regulation would be a foundation of the act.

H.R. 15303 conveys upon the Commission direct power and control over areas which Congress in the first instance delegated to the self-regulatory bodies. This bill would strain the regulatory and administrative responsibilities of the Commission and there is great danger of the whole regulatory structure breaking down under its own weight and proving ineffective.

Increased direct Government regulation would have the following adverse effects:

1. Pronounced expansion of the organization of the Securities and Exchange Commission in terms of staff and multiplication of branch offices.

2. Large increase in expenditure of public funds.

3. And the danger of imposing rigid regulation on a business which would limit competition and stifle growth.

It should not be forgotten that although initial responsibility in many areas is left with the exchanges, the Commission is vested today with powerful oversight powers if the exchanges do not meet their charged responsibilities.

In addition, H.R. 15303 amends section 19(a) of the Securities Exchange Act by adding a provision providing Commission review of disciplinary actions by self-regulatory organizations against their

members. These amendments, as do the amendments to 19(b), increase direct governmental regulation with the inherent adverse effects of expansion of the Commission organization; increased expenditure of public funds; and restrict competition by imposing rigid regulation.

The PBW certainly does not oppose Commission review of disciplinary action taken by the Exchange against a member, or person associated with a member. However, the Exchange is troubled that the amendments to section 19(a) may be interpreted as creating an affirmative duty by the Commission to review all disciplinary actions by the Exchange. Such an interpretation would create overwhelming administrative problems for the Commission.

Finally, the PBW believes that due process and fair dealing are provided in disciplinary actions by the Securities Exchange Act of 1934, the PBW constitution and rules, and by judicial review.

Thank you, Mr. Chairman.

(The full statement of Mr. Wetherill may be found at p. 319.)

Senator WILLIAMS. Thank you very much, Mr. Wetherill.

Let's start. I do not know how long we can continue and I do not know how long you gentlemen can stay, but first, I gather there is a general feeling that any meaningful change—an approach to any basic new regulatory structure—really should wait on the new marketplace. We call it the central market system. What did you call it, Mr. Calvin?

Mr. CALVIN. Central exchange system.

Senator WILLIAMS. What is the difference?

Mr. CALVIN. Well, the difference is that we feel, and our Board took a policy position on this at its special meeting a week or so ago, that the auction market system, which is the base of our securities industry in this country, should be continued and any new system which is developed and evolved should be a central exchange system, where essentially trading takes place in an auction method as opposed to a dealer system of the type which is the most commonplace in the over-the-counter markets.

I would be willing to submit the paper on the position the board took on the matter for the record. It might be helpful at this point. I do not have a copy with me.

(The following material was subsequently submitted for the record:)

NEW YORK STOCK EXCHANGE, INC.,
New York, N.Y., September 25, 1972.

HON. WILLIAM J. CASEY,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN CASEY: The Board of Directors of the New York Stock Exchange is very much aware of its public responsibility in providing disclosure not only of last sale information but of bid-asked quotations in NYSE-listed securities. It, therefore, seeks to take a constructive step in endorsing the concept of a competing quotation system, but one which is centered in exchange markets.

The enclosed memorandum, describes a specific proposal which would be the first step in moving toward such a system. The Board specifically recommends that the SEC require all exchanges to furnish each other with bid-asked quotations on a reciprocal basis. As you know, our present policy limits the distribution of bids and offers to NYSE members. We are persuaded, however, of the desirability of modifying this policy. We would expect regional exchanges to reciprocate by making their quotes available to our Floor. It would be our intention to install appropriate visual displays at each post showing quotations for each listed security in all exchange markets.

For reasons developed in the enclosed memorandum, it is essential to the concept here proposed that all transactions in listed securities would be handled through over-the-counter dealers. We are concerned that any system of competing quotations which includes non-exchange market makers would lead to the creation of a dealer market and would move the industry in a direction opposite to a central auction system.

An auction market system holds many advantages for the public, particularly the preservation of a "crowd" where buyers and sellers can negotiate their trades. In such an auction exchange system, market makers need intervene only at times when there is a significant imbalance between the supply and demand for stocks. This, of course, is quite different from a dealer market which, we believe, would weaken and perhaps destroy the securities exchanges which have served our economy so well.

The enclosed memorandum also points out that our proposal would preserve the competitive vitality of regional exchanges whose strength might be sapped as the cut-off point for negotiated commissions is lowered, and as uniform rules for institutional membership are adopted.

We hope that the Commission will approve the basic concept here being proposed. It would provide for increased competition and the preservation of an auction market system which should be the hub of any future new central exchange market.

Very truly yours,

JOHN J. MULCAHY, Jr.

NEW YORK STOCK EXCHANGE, INC.,

September 25, 1972.

MEMORANDUM

To : Board of Directors.

From : William C. Freund.

Subject : Proposal on competing quotations.

Among the critical issues that will shape the future structure of the securities industry is the proposal for a system to disseminate competing bid-asked quotations in NYSE-listed securities.

In February of this year, the Securities and Exchange Commission issued a statement of policy favoring public disclosure of prices, volume and quotations for all securities in all markets. In March, the SEC gave notice of proposed rules to implement that policy.¹ Subsequently, the SEC appointed an Advisory Committee to make recommendations regarding the dissemination of last sale and bid-asked quotations in listed securities.² Recommendations along these lines have also been made by witnesses before the House Sub-Committee on Commerce and Finance and the Senate Sub-Committee on Securities.

In May of this year, the Exchange presented to the SEC a new plan to accomplish complete disclosure of last sale prices for all trades in listed stocks in all markets. This information would be made available on stock tickers and recall devices on a market-identified basis through existing vendors of market information, using the facilities of the Securities Industry Automation Corporation (SIAC). That concrete proposal was a constructive step to bring about the reality of a central market system.

It is now up to this Board to take an equally constructive step toward the development of a system of competing quotations. It is recommended, therefore, that the Board endorse the concept of a system of competing quotations, but one which is centered in the exchange markets.

The first step in moving towards such a system would be for this Exchange to recommend that the SEC require all exchanges to furnish each other with bid-asked quotations on a reciprocal basis. Our present policy limits the distribution of bids and offers to NYSE members. Modification of this policy should be considered as a step toward fuller disclosure of essential market information.

¹ The notice of the proposed rule stated explicitly that it would "require every registered national securities association, with respect to over-the-counter quotations in securities listed or traded on the exchanges, to make available to vendors quotations of over-the-counter market makers."

² So far, this Committee has filed its recommendations on last sale data only.

We would expect the regional exchanges, of course, to reciprocate by making their quotes available to our Floor. It would be our intention to install appropriate visual displays at each post showing quotations for each listed security in all exchange markets. We would also take steps to assure that quotations are completely current. Such a program could be integrated with floor automation plans presently being devised.

It is essential to the concept here proposed that all transactions in listed securities be excluded through exchange markets, while trading in unlisted securities would be handled through over-the-counter dealers. The reason for this stipulation is concern that any system of competing quotations which includes third market makers would lead to the demise of the auction market system to the disadvantage of the public.

An auction market is a system where buyers and sellers meet to transact their business. Normally, agents of buyers and sellers negotiate their trades in an auction market "crowd." Buy and sell sides are brought into balance through adjustments in price. Most of the time buyers and sellers are able to trade inside the dealers' quotations. At times, there will be significant imbalances between the amount of stock demanded and the amount supplied. In those instances, and then only, the specialist is expected to step in as a dealer to maintain an orderly market.

An auction market, with its public benefits such as described above, is unlikely to survive a quotations network for dealers acting as principals in NYSE-listed stocks. Such a network would eliminate the auction market at least on one side of each trade. Member firms acting as agents on behalf of the public would deal with market makers directly as principals. In time, larger member firms would have an incentive to become dealers themselves rather than to route their trades via an auction market. Moreover, institutions could deal directly with market makers as principals, just as they do now with third market firms.

With these developments, many members and member firms would have little incentive to execute orders on exchanges. They could operate as "upstairs" dealers with much the same exposure to the flow of orders. The reason members have conducted their activities on the Floor of the NYSE has been the opportunity to serve the flow of public orders as agents and dealers. These orders have provided the incentive for specialists to subject themselves to our rigorous requirements relating to capital and market making and the inducement for specialists to maintain orderly markets in hundreds of less active stocks. If, however, specialists can expose their quotations to public orders by becoming third market dealers, and if they can then pick and choose their stocks, they will no longer have any reason to continue to accept special NYSE obligations and to conduct their activities as members of an exchange.

We believe that the substitution of a dealer market system for the present auction exchanges would impact adversely on the investing public. It is against the public interest to risk destroying the delicate mechanism which now exists for interfacing individual and institutional orders in an active auction market. We ought not to risk the destruction of a mechanism which provides best execution through traders in a crowd.

This proposal would give encouragement to the maintenance of exchange markets and to active competition among them. Indeed, the proposal for a system of competing quotations among exchange markets would strengthen the regional exchanges and their ability to provide effective competition in market making. As the break-point for the negotiation of commission rates is lowered, and as common rules for institutional membership are adopted, the role of regional exchanges may well be threatened. This proposal could preserve their competitive vitality. Equally important are the benefits to the public interest which would flow from a stronger agency auction market system; ready access to competitive quotations on all exchanges; the preservation of market making obligations at times of supply-demand imbalances; the maintenance of orderly and continuous markets; the interfacing of individual and institutional orders; and retention of market making responsibilities in lesser known companies, thereby facilitating capital formation in growth areas of the economy.

The strength of the American securities markets has rested on its auction characteristics which have made it the best in the world. As a matter of national policy, emphasis should be shifted from fostering the development of principal-dealer markets to bolstering the unique continuous agency-auction markets provided by the exchange system. For these reasons, the Board should direct the staff to move toward rapid implementation, with appropriate SEC oversight, of

a system for inputting and disseminating bid-asked quotations of competing exchange markets in all listed securities.

Such a system should, of course, provide for appropriate uniform market rules which will make bid-asked quotations truly comparable.

WILLIAM C. FREUND.

Senator WILLIAMS. Commissioner Loomis, could you comment on this, which is more than a semantic difference, is it not?

Mr. LOOMIS. Yes. There is a rather fundamental difference inherent in this. The Commission has not taken action on this proposal which has been submitted to it by the New York Stock Exchange. We feel that it would, among other things, be premature for the reason you earlier expressed that we do not know the structure of the market that will be existing in the future yet.

But this Exchange proposal does appear to contemplate that listed securities can be traded only on exchanges. I believe it says that.

Mr. CALVIN. That is correct.

Mr. LOOMIS. And that would mean that the third market would be abolished. That does not necessarily mean the third market-makers would be abolished. They could go join an exchange, but it does mean that the third market, as such, would be abolished; and I think that is a difficult question.

It is contrary to the stated position of the Commission both in its statement of the future structure of the securities markets and earlier in its transmittal of the Institutional Investor report.

Senator WILLIAMS. Now, on the central market system, there are basically three institutions that have a responsibility or an authority to deal with the new system: the Securities and Exchange Commission, the Congress, and the self-regulatory agencies.

Who should take the initiative and who should begin the description of the new market system? Mr. Loomis, do you want to start off with that?

Mr. LOOMIS. Well, I do not have any clear answer to that. I do not think it is possible for the commission or for the Congress at this moment to lay down a precise structure either in a statute and we could not do it by rule anyhow—only the Congress could do it—as to exactly how the central market system should operate. We think that initiative should and hopefully will come in this area from the industry because all of the organizations in the industry favor some kind of a central market system, and as they develop plans and proposals these should be reviewed by initially the commission and by the Congress.

The problem of developing an industry position is the one I alluded to in my statement, that various segments of the industry have different interests. But the industry as a whole can present ideas, concepts, operating procedures, and then these can be evaluated and the Congress ultimately will make the decision.

Senator WILLIAMS. You say they can present them. Who are they going to present them to? To you?

Mr. LOOMIS. They can present them to us. I would hope they would.

Senator WILLIAMS. Well, is this going to be in response to a call? It is not just going to happen.

Mr. LOOMIS. Well, we have tried to start the process moving by setting up an advisory committee on the future market structure. They have not as yet reported. When they report we will review their report.

I would expect we would submit to the various industry organizations, in effect, a call to come up with something.

Senator WILLIAMS. This advisory group now, everybody is represented on the advisory group—everyone here?

Mr. LOOMIS. I can give you a list of the members of the group but I do not have it with me.

Senator WILLIAMS. All exchanges and the NASD, third market?

Mr. LOOMIS. They were not established as representatives of particular organizations. It was not set up that way. We just wanted a group of people knowledgeable in the functioning of the industry, and independent, to give us advice. I can provide for the record a list of the members. They are not all drawn from the industry. They include certain people from private life who are knowledgeable.

(The following information was received from Mr. Loomis:)

ADVISORY COMMITTEE ON A CENTRAL MARKET SYSTEM

Richard B. Walbert¹ (312) 782-3900, Halsey, Stuart & Co., Inc. (president), 123 South LaSalle Street, Chicago, Ill. 60603.
 William B. Eppler (214) 744-0511, Eppler, Guerin, & Turner, Inc. (EVP), 3900 First National Bank Building, Dallas, Tex. 75201.
 Walter N. Frank, Sr., (212) 349-1080, Walter Frank & Co. (partner), 120 Broadway, New York, N.Y. 10005.
 Alan Greenspan, (212) 943-9515, Townsend-Greenspan & Co. Inc. (president), One New York Plaza, New York, N.Y. 10004.
 Jerome H. Grossman, (213) 624-3333, Jefferies & Co., Inc. (EVP), 445 South Figueroa, Los Angeles, Calif., 90017.
 Paul R. Judy (312) 786-5000, A. F. Becker & Co., Inc. (president), Two First National Plaza, Chicago, Ill. 60670.
 Jack Nash (212) 825-4000, Oppenheimer & Co. (partner), One New York Plaza, New York, N.Y. 10004.
 Ralph S. Saul (212) DI 4-1515, The First Boston Corp. (vice president), 20 Exchange Place, New York, N.Y. 10005.
 John H. Schwieger (212) 437-2818, Paine, Webber, Jackson & Curtis Inc. (vice president), 140 Broadway, New York, N.Y. 10005.

Senator WILLIAMS. You know, the whole thing seems murkier after this little discussion than we started. You can see that Congress is not equipped to take initiatives here in depth in this.

Mr. LOOMIS. I must say I agree with you entirely. As I said in my statement, everybody is in favor of a central market system, but no one knows yet what it is going to be. I think we will have to try to push that along as best we can. We will appreciate and need the support of the Congress and the initiative of the industry.

Mr. CALVIN. Just to supplement and amplify on some of the things Commissioner Loomis said, the real origin of these discussions, the moving force behind the discussions of a central exchange and a central securities system or a national exchange system, in recent time at least, stem from Mr. William McChesney Martin's report.

In that report he recommended the creation of a national exchange system. That report was presented to the Board of Governors of the New York Stock Exchange in August of 1971. In September 1971, the then Chairman of the New York Stock Exchange, Mr. Ralph DeNunzio, called a meeting of the exchanges and the NASD as represented at this table, as well as three other stock exchanges who are not represented here today.

¹ Chairman.

As a result of that meeting, it was decided to try and develop a definition of a central market system so that a determination could be made by the governing boards of these various organizations as to whether they would support such a system and move to implement it. Those meetings began, as I say, in September of last year.

Following the initial meeting, a working committee was created, which is composed of the organizations represented at this table today. That group first met in September of last year and held their most recent meeting a month ago, that is to say, on September 6.

Those discussions were reported to the Commission. The Chairman of the Commission, in fact, was present and participated in one of the most recent meetings held in July. The discussions initially began to focus on the developing of a definition of a central market system. The work which resulted from those discussions was presented to the SEC in testimony at hearings which they held starting last October. The American Stock Exchange initially presented the definition, as did those of us who appeared on behalf of the New York Stock Exchange in October of last year, as did the other gentlemen at this table in their appearances at those hearings.

Then, in November of last year, it was decided that these discussions should focus on the creation of a consolidated tape. Since then discussions relating to a consolidated tape have occupied all of the discussions from last November up until September 6, the time of the last meeting. As a result of those discussions, there developed some difference of opinion as to how a consolidated tape might be implemented.

Following that, the Commission became involved in the issue by releasing for public comment, two proposed rules dealing with these various matters. These proposed rules were issued for public comment in March of this year. These rules, rule 17(a)15 and 17(a)14, were circulated for public comment at that time.

At about that same time, the Commission also named three advisory committees, including the advisory committee on the central market system which Mr. Loomis has referred to. One of those advisory committees dealt specifically with the consolidated tape and it issued its first report on July 17, I believe it was, of this year.

Following the issuance of that report, there was a meeting of this working group—the exchanges represented here and the NASD—and the Commission subsequently recirculated for public comment its revised proposed rule 17(a)15.

I think all of us within recent days have submitted our comments. The New York Stock Exchange, for example, submitted a comment, a simple comment, to the effect that we support both the objectives of the Commission's rule in this area and also support the specifics of the proposal. In other words, we are almost in total support of the Commission's proposal which has evolved as a result of these events which I have described very briefly.

We on the working committee have been most recently discussing the creation of an association which would dovetail with the implementation of the Commission's Rule 17a-15, should the Commission adopt it. As a matter of fact, we have recently been in communication with one another on creating such an organization that would be the moving force behind a consolidated tape in the industry. I would expect that this working group would continue to be a moving force

toward the creation of a central exchange system, central market system, what-have-you, in the coming months, as well as over a longer period of time.

I think we all want to have the initiative and I think I speak for all of us here. That is to say, we, the industry, want to have the initiative in this area. I think we are willing to assume that responsibility. I think we have assumed it. We want to work very closely with the Commission in connection with exercising that initiative. I think we have done so. I think we also want to work closely with the Congress in exercising that initiative and we have done so, especially in the hearings that were held earlier this year before the House Subcommittee on Commerce and Finance.

In the House Committee on Commerce and Finance report, which was issued publicly last August, they, in a way, embraced much of the work which this group had done. In my own view, the definition which is being talked about of the central market system is a definition that these gentlemen on this working committee developed beginning in these discussions last fall. This is the type of initiative which I think will continue. I think it is the proper way to proceed in that we have the expertise. We also have all types of interest in having such a system created. We can get inputs not only from our own boards but from other people in the industry and outside the industry who are vitally interested in these issues.

I agree with what the Chair said, if I understood him correctly, that this is really not an area where the Congress should be expected to exercise its initiative unless, I would add to that, the industry and the SEC fail to do so. I see no such failing here and I do not expect there will be.

Mr. LOOMIS. I should have mentioned—and I was planning to do so—that a great deal of progress has been made, as Mr. Calvin has outlined, on this question of the consolidated tape which, of course, is one of the cornerstones of the central market system.

Senator WILLIAMS. Well, given present developments, let me ask one or two specifics. As you see it now, what is the role and what are the prospects for the regional exchanges in this central market system as you now see it in the early stages? And where does the third market fit into this? Does anybody want to offer a comment on that?

Mr. TOBIN. Speaking for one regional exchange, we are looking for a much freer field of competition than has obtained in the past to result from what we see developing in the central market system. I think that competition is going to be beneficial all around and I guess it is obvious, since I endorse that kind of competition, that I expect to see at least one regional exchange fare well under the national market system.

Senator WILLIAMS. Well, it would seem to me that that should follow with the consolidated tape. Now, that's 17a-15? Is that the Rule?

Mr. TOBIN. I think, Mr. Chairman, the consolidated tape is the first and very important, vital, if you will, step; but there are other steps which have to be taken to achieve the kind of competition I am thinking of.

Senator WILLIAMS. From my information, 17a-15 deals with quotations; and just how does that fit the picture here in terms of Mr. Tobin's observations on a more competitive marketplace out of these developments that are underway?

Mr. LOOMIS. Well, the proposed Rule 17a-15 deals with the dissemination of quotations. The advisory committee has not reported on that as yet. I gather there are some differences of opinion with respect to it, but the basic outlines will I think come clear. Deliberately this was deferred to a degree until more work was done on the consolidated tape, and the consolidated dissemination of quotes is the next step.

Mr. CALVIN. May I, just on behalf of the New York Stock Exchange, lend our support to the comments which Mr. Tobin made. I think the great benefit which will accrue as a result of the creation of a central exchange system will be greater competition between the existing marketplaces. If the regional exchanges continue to compete as they have in the past, they should have greater success in the future than they have had in the past.

What has been happening here, Mr. Chairman, as I said, is this working group began addressing the question of the consolidated tape, feeling that this was the first priority. My own view is that that issue, from a policy standpoint, is almost behind us in that the Commission has now proposed a rule which I personally expect they will adopt shortly. That's my own personal view. The comments which have been submitted by the New York Stock Exchange, as well of the organizations here—at least the ones I have read—support the proposed rule. There are some reservations in some cases—not on the part of the New York Stock Exchange, but there are some reservations, but I would categorize those as minor.

The next step, then, is to develop a system of competing quotations. It was in this connection that the New York Stock Exchange issued the proposal which it did on September 25. Our board proposed at that time to the Commission that there be created a system of competing quotations. That is to say that the quotations from the New York Stock Exchange be made available to all regional exchanges and that they do the same.

The key element in this, in our view—and we feel very strongly about this—is that what is necessary to be preserved under any central exchange system is the auction market system which we have today. That is to say where public bids and offers can be brought together in a crowd of brokers and a true auction take place, where one or more dealers dealing for their account do not dominate the market or, in fact, constitute the market. This is the reason why we think trading in this new system should take place on an exchange. I think once one considers the logic of that you would have to agree with it. The whole exercise here is to create a system, because what has happened in recent years is that trading has moved away from the organized exchanges and is taking place in a more private way in some areas. This is what some people call fragmentation of the markets. If there is any merit to creating a system, it is to eliminate that type of activity and so, ultimately, it will be necessary that it be mandated, that all trading in securities in the system take place in the system. If that does not happen, then there will be trading outside the system and the whole exercise then will have been for naught, at least in my opinion. We want to preserve—and I think it is clearly in the public interest to do so—to preserve the auction nature of our markets and not move to dealer markets, particularly in those securities which are currently traded on the exchanges.

Senator WILLIAMS. This is saying—accepting broadly now the consolidated tape and the proposal on quotations—really, there is no place within the picture of the central market system, as you are describing it, for that other element that is now in existence, the third market?

Mr. CALVIN. Yes and no to that. In other words, the third market or whatever one calls it—all trading in listed securities should take place in the system is what we are saying, and that system should be an auction market system like one has today on the exchanges. Many of the third market firms are, in fact, members of an exchange and do some of their dealings on an exchange. If you create a system where some dealings take place in the system which is the exchange system, and some outside it, then, I personally question the value of creating the system. The value of creating the system is as it implies, to have a central system, one system.

We are not suggesting, and no one has suggested at this table at least—some people have outside—that the existing exchanges be done away with and something new be substituted in their place. We are not suggesting that.

Senator WILLIAMS. Anything else to be offered on this?

Mr. KOLTON. I just wanted to add one thing to the point Mr. Calvin made and another way of getting to your question. I think it helps if you start with a definition of what a central market system or a central exchange system is designed to do. If one of the main things that that system is designed to do is to protect public orders within the system to make sure those orders are routed to the best market and assured an execution in the best market, then questions about the third market and where they fit fall by the wayside.

We have assumed that the public order that enters the system—that is, captured electronically—that is switched to the best market, that is assured of the best execution, is going to be executed within the framework of an auction market system. By that definition, if that is an acceptable definition, we would see the third marketmaker involved in the system with a concomitant sense or set of responsibility.

Mr. MACKLIN. As we said earlier and I think we all agreed to this, the outline and shape and form of the market system of tomorrow is still very hazy, and I think that economics and evolution will lead us toward that system and give us a clearer look at it as time goes by. I think that steps like full disclosure of all transactions on a common tape are a big step forward.

We believe that putting all competing quotations in one system is another step forward and, of course, obviously, we do not share the view that a quotation has to come from a specific exchange location to be competitive or meaningful. We think, truly, all quotations should be allowed to compete against each other.

As to the current posture of the third market, they are here and alive and well, and performing a function, that is providing liquidity particularly for institutional investors, and we have been working with the third market people to help them step along toward the central market system or the market system of tomorrow in two ways. We have a committee of leading third market dealers that are working on the problem of disclosure of transactions and quotations for all third marketmakers, and rules of trading for all third marketmakers to live with.

I do not believe that the third market will be eliminated by Government fiat. The immediate future, I believe, will require more disclosure for the third market and more rules—rules that are related to public interest and the manipulative rules and marketmaking responsibility type of rules rather than access of membership kind of rules. Those are in the immediate future.

For the long-term future, I think it is hard to define where the third market maker or that dealer that is now a third market maker fits into the central market system until you also define just what are the roles and privileges and right of the specialists and other people that are currently making markets. When you clearly see those, you can clearly see the others.

But, in the meantime, we will work toward a central market system by doing those things that we clearly see to be in the public interest, forced disclosure, and build a set of rules that are meaningful.

Senator WILLIAMS. Thank you. We are going to leave this point unless anybody else has something.

Mr. LOOMIS. I would just like to say one thing. I agree with Mr. Calvin that there should not be markets which are outside the system. You have the problem which Mr. Macklin has alluded to as to what is inside the system or what is not.

Senator WILLIAMS. We have developed many questions. A lot of them have been answered directly and in response to this discussion. There is one area that has received quite a bit of attention lately, and that is who is to be in a regulatory posture with respect to new issues that are described as "hot" issues. That has come to the top. There is public interest, if the press is a barometer of that. I gather this is a NYSE/NASD question at this point.

Mr. CALVIN. I will begin and then ask Mr. Macklin to supplement, because there is no difference in opinion between the NYSE and the NASD on this point, press reports to the contrary, Mr. Chairman.

Senator WILLIAMS. That happens.

Mr. CALVIN. And that turns on the first exhibit which I handed up earlier. That is to say this press release of October 3, in which our Chairman, Mr. Needham, announced appointment of a committee to consider whether the Exchange should have guidelines for its membership regarding the sale of new issues of securities.

Now, that action, as explained in this release which I hope will be a part of this record, arose as a result of the Commission's having issued a report in early August dealing with "hot" issues—"hot" new issues of securities. In that report, as I recall, the recommendation was made that the NASD and the exchanges—and I remember specifically the New York Stock Exchange was mentioned—adopt standards for its members dealing with the suitability of sale of new issues to their customers.

Following the release of that report, the Chairman of the New York Stock Exchange received a letter from the Chairman of the SEC—this would have been in August of this year—pointing to that recommendation and asking that the Exchange respond to that recommendation by September 15. The requested response was for our reaction to this proposal that we consider adopting rules with respect to the suitability of sale in the new issue area.

In response to the Commission's request, we discussed this matter with our Board on September 7. The recommendation was made to the members of the Board that they authorize the Chairman to appoint a committee to review this area. The committee was named and appointed earlier this week.

Now, this committee is going to determine what, if any, action the New York Stock Exchange should take in this area. There is absolutely no question that if there are recommendations which would, in any way, impact on current NASD activity, they will be discussed and explored with the NASD prior to any implementation of these recommendations. This committee has not met so I do not know if there will be recommendations along these lines, but, in effect, we are responding to a request of the SEC. We are not moving in this area of our own initiative.

Senator WILLIAMS. Who wants to answer the question: What makes an issue "hot" and what are the problems here in "hot" issues?

Mr. MACKLIN. Well, I think by definition, an issue that is "hot" is one that has an immediate rise in price after it comes to the market. One of the problems with "hot" new issues is that if there is an immediate rise in price, it probably is apparent before the issue comes out because the potential demand exceeds the supply; and when you have a commodity that is selling at \$10 today that will probably sell at \$20 tomorrow, the mere granting of some of that stock to another person is the equivalent of allocating money. One of the problems relates to free riding. Who gets these allotments when a stock is "hot"?

I think the new issue distribution problem has been misnamed the "hot" issue problem just because there were so many issues of that type that came out a few years ago, but the new issue problem, much of it, centers on what you might call "cold" issues because a year or two after they come to market the companies are not doing well. The problems that we are focusing on are first and foremost the underwriters' exercise due diligence before he agrees to commit his firm to do a particular underwriting. Second, in the distribution process, the salesman's efforts to see that—particularly in the new and unseasoned stocks—to see that they are distributed to people who can afford that type of risk. A third problem the Commission has raised relates to the question of what is truly a bona fide offering versus one that might have a restricted supply or other features that would cause an irregular market.

So the "hot" issue problem is poorly named to the extent that it relates to the distribution of new issues.

Mr. LOOMIS. I would agree with much that has been said by both Mr. Macklin and Mr. Calvin. I do feel that the Commission's position, as I understand it—and I may be wrong—should be clarified a little.

We saw a problem, which we identified in our report, in the "hot" issue area and in the distribution of brand new issues generally. We solicited the views of all interested persons on that or all interested bodies.

With respect to suitability specifically, the exchanges as well as the NASD have for many years had rules and policies dealing with the obligations of their members to recommend issues which are suitable for the particular customer, and obviously there is no desire to exclude the exchanges from continuing that salutary effort. We were not,

I believe, endeavoring to change whatever allocation of responsibility for regulating the distribution process now exists.

Senator WILLIAMS. I have a feeling we are going to be staying in business here, not at this hour, but in the days or weeks to come. This has been very, very helpful and illuminating. We appreciate your continuing cooperation.

Thank you very much, gentlemen.

(Whereupon, at 1:10 p.m., the hearing was adjourned, subject to the call of the Chair.)

(The prepared statements of all the gentlemen appearing before the subcommittee this day follow:)

REMARKS OF PHILIP A. LOOMIS, JR., COMMISSIONER,
SECURITIES AND EXCHANGE COMMISSION, BEFORE THE
SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE
ON BANKING, HOUSING AND URBAN AFFAIRS

October 5, 1972

"THE STRUCTURE AND OPERATION OF THE
REGULATORY SYSTEM IN THE SECURITIES INDUSTRY"

Mr. Chairman, I am pleased to participate in this, the last of your Subcommittee's three hearings concerning the operation of the regulatory system in the securities industry. Unlike the first two hearings held by the Subcommittee on this topic, which considered two, somewhat atypical, specific examples of self-regulatory decision-making and Commission oversight, the hearings today are concerned with the broader subject of whether the unique system of self-regulation in the securities industry is working and whether and how it should be modified. In preparing my remarks for this hearing, I have, in accordance with the Subcommittee's request, responded to the four, rather all-encompassing questions concerning this important topic that were attached to Chairman Williams' letter. Needless to say, however, these questions raise issues which are presently the subject of intensive study and reexamination by the Commission and a

number of the self-regulatory bodies as well the Congress. They go to the very heart of the future structure of our securities markets. In light of the Subcommittee's request for a very prompt response to these questions and the fact that, to a large extent, these questions can effectively be answered only after the issues concerning the future structure of our securities markets are resolved, I cannot provide definite and comprehensive answers. Indeed, as to some of these questions, I doubt if such answers now exist.

At the outset, I should like to express some general observations with respect to the self-regulatory process. The concept of self-regulation, or "cooperative regulation" as your counterparts in the House prefer to call it,^{1/} was given legislative sanction in order to accommodate the unique structure of the securities markets as they existed in 1934 and 1938. This concept reflected certain Congressional presumptions concerning the desirability of direct (as opposed to residual) government regulation over many specific facets

^{1/} Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, Report of the Securities Industry Study, 92d Cong., 2d Sess. (1972) at pp. 79-116 (hereafter, "House Study").

of the daily operations and functions of the various component parts of the securities industry and fairly prevalent views concerning the propriety of the government defining moral or ethical, as opposed to purely legal, standards of behavior.^{2/}

The fundamental concept of self-regulation embodied in the Securities Exchange Act was well-suited to the securities markets as they existed in 1934 and 1938. In light of the rather extensive changes in the securities markets and trading patterns that have occurred in recent years, however, some observers have concluded that self-regulation is no longer viable. Based upon our experience, however, the Commission cannot subscribe to this view. The system of self-regulation has served, in many areas, as a source of affirmative protection to public investors and as an important vehicle to implement the regulatory objectives of the Congress.

Nevertheless, the magnitude and rapidity of the changes in our securities markets and the resulting changes in the

^{2/} See Hearings on S. 3255 (The Maloney Act) before the Senate Comm. on Banking and Currency, 75th Cong., 3d Sess. (1938) at p. 10; H.R. Rep. No. 2307, 75th Cong., 3d Sess. (1938) at pp. 4-5; S. Rep. 1455, 75th Cong., 3d Sess. (1938) at pp. 3-4; see also, Silver v. New York Stock Exchange, 373 U.S. 341, 371 (1963) (Stewart, J., dissenting).

nature of the issues which confront all concerned with the regulation of those markets, including the self-regulatory agencies, have thrown a considerable strain upon the existing pattern of self-regulation which has, in turn, revealed certain weaknesses.

In earlier years, the self-regulatory agencies were conceived of as primarily designed to establish and enforce standards of personal conduct in the securities industry. To this task, they were expected to bring, and did bring, an awareness of the standards voluntarily observed by responsible members of the industry, and also a day-to-day familiarity with what was going on and what was right, or wrong, about it. The self-regulatory agencies have in the past, and continue at present, to make a major, and I think irreplaceable, contribution in this area.

More recently, however, the self-regulatory bodies have been confronted, by changing conditions and changing needs, with the resolution of economic issues, which bear directly not only upon the economic interests of their members, but upon the economic interests of non-members as well. In

addition, as I will discuss further in my answer to your first question, the various markets have become so closely interrelated that certain issues are highly significant to more than one such agency, and it becomes difficult to resolve these issues at an industry level without the concurrence of several self-regulatory agencies. Resolution of such common problems may be impeded by the fact that any given resolution may be seen as either advancing or as impairing the economic position of the members of a particular self-regulatory agency in relation to the members of another such agency.

In my introductory remarks before this Subcommittee on August 8, I referred to the difficulties encountered by self-regulatory agencies in coping with economic issues affecting the welfare of their members and suggested that stronger Commission oversight might be necessary to deal with these difficulties. I shall refer to that again later in this statement.

Problems of this kind elude prompt and simplistic solutions. They can and should be examined and resolved by collective and carefully considered efforts of the self-

regulatory bodies, the Commission and Congress. But I believe that there is no need to abandon or unduly encumber a system that, in many instances, has been responsive in the past to the public interest and that can be made more responsive in the future.

Although my general comments bear most directly on Question Number 4, I shall respond to your questions in the order they were presented.

1. What suggestions, if any, would you make for reallocating authority among the various self-regulatory agencies? Over which firms, and which activities, should each of such agencies exercise effective authority?

The Subcommittee's first question requests suggestions for the reallocation of the authority exercised by the various self-regulatory bodies.

In its recent report, the House Subcommittee on Commerce and Finance noted that "[t]he overall organization of the markets is now in flux. . . ."^{3/} This statement was prompted by Commission's position that, in order to improve the manner in which the securities markets serve the public, the future structure of the securities markets requires the evolution of a centralized market system, with open access by all qualified brokers and market makers.^{4/} This proposal, of

^{3/} House Study, supra, n. 1, at p. 115.

^{4/} This position was first expressed by the Commission in its letter transmitting the Institutional Investor Study to Congress and then in the Commission's policy statement on the future structure of the securities industry, issued in February of this year. See Securities and Exchange Commission Institutional Investor Study Report, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. pt.1 (1971), pp. xxiii-xxv; Securities and Exchange Commission, Statement on the Future Structure of the Securities Markets (Feb. 2, 1972) at p. 9 ("Policy Statement").

course, has been endorsed by the House Study^{5/} and has received the tentative concurrence of this Subcommittee as well.^{6/}

When the parameters and scope of the central market system are more sharply in focus, appropriate variations in the existing allocation of self-regulatory authority may well be necessary. But the structure of the central market system cannot be defined today; the evolution of the structure of such a central market system necessarily will take some time and careful consideration. Accordingly, as the House Study^{7/} and the Commission's Policy Statement^{8/} both suggest,

^{5/} House Study, supra n. 1, at pp. 117-130.

^{6/} Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Report of the Securities Industry Study, 92d Cong., 2d Sess. (Comm. Print 1972) at pp. 45-46.

^{7/} House Study, supra n. 1, at p. 115 ("Since the optimum organization of the markets is not yet clear and should not be prejudged by fiat, it is premature to prescribe the tasks of particular bodies in the new arrangement which may eventually evolve.").

^{8/} Policy Statement, supra n.4, at p. 9 ("We anticipate that during the developmental stages [of the central market system] the self-regulatory organizations will make changes appropriate to the new system. It is not necessary, however, to attempt to design at this time a self-regulatory structure for a system, the outlines of which are still not sharply defined.").

attempts at specific suggestions for the reallocation of self-regulatory authority at this time would be premature and largely unproductive.

Nevertheless, certain basic concepts of self-regulatory allocation of authority, of course, would seem to me to apply, irrespective of the definitive structure with which the central market system ultimately will be endowed. Thus, I believe coordination of self-regulatory authority and enforcement efforts, elimination of unnecessary duplication of self-regulatory efforts^{9/} and careful planning among self-regulatory bodies and the Commission will be appropriate under most, if not all, circumstances. The Commission has instituted programs in this vein, such as its attempts to coordinate various broker-dealer and investment adviser examination programs, and the Commission presently is studying ways to implement the recommendations of its Advisory

^{9/} I do not believe that all overlaps of self-regulatory authority necessarily should be eliminated. In some instances, different approaches to similar problems may result in more effective self-regulation.

Committee on Enforcement Policies and Practices concerning the need for improved coordination of self-regulatory and Commission surveillance and detection of securities law violations.^{10/}

The problem of allocating responsibility among self-regulatory agencies has also been complicated by changes in the securities markets. When the existing allocation was evolved, it appears to have been based upon the assumption, then reasonably valid, that each of the major segments of the securities market, that is, each exchange and the over-the-counter market, was more or less a self-contained entity. It was accordingly concluded, notwithstanding the fact that particular firms could, and did, do business in more than

^{10/} See Report of the Commission's Advisory Committee on Enforcement Policies and Practices, BNA Securities Regulation & Law Report No. 158 (June 28, 1972) at pp. 2, 15-16, particularly recommendations 40 ("The Commission should play an affirmative role in allocating inspection and enforcement responsibilities among the self-regulatory organizations; continuous effort should be made by the Commission and those organizations to coordinate both the timing and coverage of inspections and investigations") and 41 ("Meetings should be held on a periodic basis between the staffs of the Commission and of the self-regulatory organizations for a mutual discussion of current regulatory and enforcement problems").

one market, that it was nevertheless appropriate for there to be a self-regulatory body for each such market. ^{11/}

At present, the various markets are not, if they ever were, self-contained entities. Many regional stock exchanges now deal primarily in securities listed on the New York exchanges, rather than in local securities. There has evolved an active over-the-counter market in exchange listed securities. Securities firms doing business with the public increasingly tend to specialize in one type of business, such as serving institutional or serving retail customers, rather than specializing in doing business in a particular market. This development raises difficult questions concerning the allocation of responsibilities among self-regulatory agencies, some of which I alluded to earlier in this statement. They have led some observers to suggest a drastic realignment under which all responsibilities for self-regulation would

^{11/} Of course, the fact that a single firm does business in several markets, under the jurisdiction of several self-regulatory agencies, has created problems of allocating self-regulatory responsibility with respect to matters relating to the overall operation of the firm, such as its financial condition or the experience and qualifications of its officers and employees. These have largely been resolved by informal understandings among the self-regulatory agencies, but the problems of both duplication and possible gaps in coverage have not thereby been wholly eliminated.

be confided to one agency, confining itself exclusively to self-regulation, while other agencies would be responsible for the problems of operating the particular markets. It is not clear, however, whether self-regulatory responsibilities can practically be separated from operational responsibilities, although if this were practicable, it would simplify matters by sharpening the focus of each agency's responsibilities. As I indicated earlier, I do not believe that this and other questions of allocation of responsibility can responsibly be resolved until we can see more clearly the structure and nature of the markets to be regulated, including particularly the evolution of the central market system. There is remarkable unanimity as to the desirability of a central market system, but still considerable uncertainty as to what it will, in practice, be.

2. What rules should apply to the composition of the governing boards of the self-regulatory agencies, and to the manner of selecting members of those boards?

The Subcommittee's second question seeks guidelines with respect to the establishment of rules setting forth criteria for the appropriate composition of governing boards.

The composition of governing boards of self-regulatory agencies was, as you know, a matter of deep concern to the Congress that adopted both the Securities Exchange Act of 1934 and the 1938 Maloney Act amendments to the Securities Exchange Act. Then, as now, concern was expressed that limited economic or other factional groups might dominate the government of the exchanges or other self-regulatory bodies.

Thus, Section 19(c) of the Securities Exchange Act directed the Commission to make a study, among other things, of the rules of national securities exchanges with respect to the methods employed to elect officers and committees to insure fair representation of the membership of these

exchanges. The Commission, in its study,^{12/} made a number of recommendations for voluntary, as opposed to legislative, changes which could be effected to improve the government of the exchanges. Many of these so-called "reforms" ultimately were implemented by the exchanges.

Similarly, the legislative history of the Maloney Act makes clear that the securities association it envisioned was to be, strictly speaking, a "democratic organization."^{13/} Congress and interested observers paid great heed to the suggestion that, in light of the strong economic compulsion

^{12/} Securities and Exchange Commission, Report on the Government of Securities Exchanges, H.R. Doc. No. 85 74th Cong., 1st Sess. (1935) at pp. 5-13.

^{13/} See Securities and Exchange Commission, Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 (1963) at p. 608 (hereafter, "Special Study"); Hearings on S. 3255 Before the Senate Comm. on Banking and Currency, 75th Cong., 3d Sess. (1938) at p. 22 (statement of Commissioner Mathews); see also, Hearings on S. 3255 and H.R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 75th Cong., 3d Sess. (1938) at p. 15 (statement of Commissioner Mathews).

to join a registered securities association,^{14/} "monopoly and oppression of the 'little fellow' and minority segments of the business" was a real evil to be avoided.^{15/}

Of course, any consideration of the proper governance of the self-regulatory organizations also must encompass an awareness of some of the unique characteristics and problems which self-regulation presents. A self-regulatory body draws its membership largely from members of the regulated industry. This is a source of strength insofar as these members bring to the regulatory task practical business judgment and experience - attributes which hardly can be duplicated in a government agency. But this essential self-regulatory "fact of life" also may pose problems, since self-regulatory decisions could be influenced by a desire to promote the economic interests of the members, of a particular group of the members, or by a wish to preserve or obtain a competitive

^{14/} See, e.g., H.R. Rep. No. 2307, 75th Cong., 3d Sess. (1938) at p. 9; Special Study, supra n. 13, pt. 4 at p. 605; National Association of Securities Dealers, 19 S.E.C. 424, 441 (1945).

^{15/} Special Study, supra n. 13, pt. 4 at p. 608.

advantage. Thus, an over-emphasis on the "self" in "self-regulation" could result, on occasion, in an under-emphasis on the needs of the public.

I believe, therefore, that the rules relating to the governing boards of all self-regulatory organizations should, as set forth with respect to the National Association of Securities Dealers by Section 15A(b)(6) of the Securities Exchange Act, "assure a fair representation of its members in the adoption of any rule. . .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 NASD explicitly provide for the appropriate representation on its governing board of various types and classes of members - not only with respect to geographic location, but also with respect to function.^{16/} And, the nation's securities exchanges also have been making concerted efforts

^{16/} See Article IV, Sec. 3, of the By-Laws of the NASD.

to effect an appropriate balance of competing interests
17/
 in a similar manner.

Similarly, there has been a commendable increasing awareness on the part of the self-regulatory organizations that their activities affect not only their limited constituencies but the investing public at large. The rules of these organizations provide for the selection of non-member, 18/ or "public," directors. Thus, for example, as you are aware, the New York and American exchanges recently have reorganized to provide that almost half of their governing board positions 19/ shall be filled by public directors. And, the NASD has amended

17/ See, e.g., Article II of the Constitution of the New York Stock Exchange, which, among other things, requires that a certain number of members of its Board of Directors (1) represent firms having "substantial direct contact with securities customers"; (2) represent a firm residing and having a principal place of business outside metropolitan New York; and (3) represent registered specialists. See also, Article II of the Constitution of the American Stock Exchange; Article III, Sec. 2, and Article IV, Sec. 4(b), of the Constitution of the Midwest Stock Exchange.

18/ See n. 17, supra.

19/ See the references to the Constitutions of these exchanges in n. 17, supra.

its By-Laws to permit its Board of Governors to select one or more Governors-At-Large from the public. ^{20/}

It is, of course, too early to tell precisely how effective the specific measures being implemented by these self-regulatory organizations will be. But the guiding principles that led to their adoption are sound, and, in my opinion, generally in accord with the broad policies enunciated by Congress in its enactment of the Securities Exchange Act and the Maloney Act amendments, as well as with the views enunciated in the Commission's Policy Statement. Whether and what modifications may be required to implement these policies is a matter that I believe should be left, at least in the first instance, to the determination of the self-regulatory agencies. Of course, I believe that appropriate residual authority should be vested in the Commission to insure that these salutary objectives are indeed met. The legislative proposals of H.R. 15303, in my view, would permit the Commission to carry out this supervisory responsibility and insure that the public interest is adequately protected.

^{20/} See n. 16, supra. One "public" member of the Governing Board of the NASD already has been selected by the other Governors of the NASD.

3. What suggestions, if any, would you make for improving the procedures followed by the self-regulatory agencies in adopting rules and policies, and in conducting disciplinary proceedings?

The Subcommittee's next question requests my views with respect to possible improvements in the procedures employed by the self-regulatory agencies in quasi-legislative and adjudicatory decision-making.

As I indicated in my introductory remarks before this Subcommittee on August 8, the Securities Exchange Act of 1934 says very little about the internal decision-making processes of the self-regulatory bodies, as distinct from the substantive standards to which their decisions must conform. That Act includes general principles such as "fair administration" and "fair representation," together with a fairly specific procedural outline for disciplinary decisions of the NASD found in Section 15A(b)(9) and (10). The general decision-making pattern for these bodies which appears to have been contemplated, and as it has evolved, seems to be modeled on that generally prevailing in the United States among private associations or corporations formed not to

conduct business for a profit, but to provide services or other benefits to their members, or to the general public, or both. The pattern includes a governing board elected by the members, and a staff assigned to serve the board and carry out its decisions. The significance of the staff has been increased as the organizations have established the position of a full-time salaried chief executive officer. Structural or major decisions such as amendments to the Constitution and By-Laws and significant substantive rules^{21/} generally require approval by vote of the membership.

It is my opinion that the self-regulatory bodies should be required to afford an opportunity for general public comment on all proposed rules having any significant impact, either upon their membership as a whole or, particularly, upon non-members. I understand that the self-regulatory bodies already are making valuable efforts to implement this objective. Thus, for example, the NASD is increasingly

^{21/} But see, Hagen Investments, Inc. v. Securities and Exchange Commission, 460 F. 2d 1034 (C.A. 10, 1972), upholding the NASD's rights to cope with emergency situations without the need to resort to a full membership vote.

exposing its rule proposals to public scrutiny and comment, and, as I have already indicated, the major exchanges are significantly expanding public participation in their governing boards. And, just recently, the American Stock Exchange submitted to the Commission a proposal to accord exchange members and other interested persons an opportunity to comment upon major rule and policy proposals before ^{22/} their final adoption by the Exchange's Board of Governors. I am confident that, as experience with these new procedures is obtained, further improvements will follow. Naturally, the benefit of these procedures is dependent upon the way they are in fact implemented. But I am in accord with the philosophy embodied by these new policies.

^{22/} Depending upon the nature of the issue involved, the American Stock Exchange has indicated that it may solicit written comments or entertain oral presentations. I have annexed a copy of the AMEX's letter to this statement for the Subcommittee's convenience.

Similar developments have occurred with respect to self-regulatory disciplinary proceedings. Thus, in the last several months, both the New York and American exchanges have submitted proposals to revise their proceedings.^{23/}

These steps represent initial efforts to alleviate some of the criticism that has been directed toward exchange disciplinary proceedings.^{24/} This is one area where the Commission has recommended that it be given greater powers of governmental oversight than presently exist.

^{23/} The proposals of the New York Stock Exchange would provide, among other things, right to counsel and an opportunity for a hearing before a panel composed of a chairman (a member of the exchange staff) and at least two exchange members in the case of an action involving a member, or at least two registered persons or employees in the case of actions against registered representatives or employees. The Board of Governors will act as a review body and review will occur at the request of the staff of the exchange, the respondent or at least a single governor. Continuing the present practice of the exchange, written transcripts of each proceeding will be prepared and the Commission has requested that a digest of each proceeding be furnished to each governor so that the review power may be effectively and expeditiously exercised. The American Stock Exchange has adopted comparable substantive provisions with some variations.

^{24/} See, e.g., Intercontinental Indus., Inc. v. American Stock Exchange, 452 F. 2d 935 (C.A. 5, 1971), petition for certiorari filed, 41 U.S.L.W. 3042 (U.S. April 25, 1972) (No. 71-1378).

The Commission also is considering the recommendations of its Advisory Committee on Enforcement Policies and Practices concerning increased publicity for self-regulatory disciplinary proceedings.^{25/}

I think that we are witnessing important progress toward the improvement of the self-regulatory process within the existing framework of the federal securities laws. Coupled with the Commission's proposals for legislation in this area, I am confident that there will be more improvements in the future. But in this connection, I would like to stress again the Commission's belief that, by and large, the existing self-regulatory scheme has proved to be flexible and durable, allowing the self-regulatory bodies to engage in experimentation and develop innovative programs. I do not believe that the self-regulatory bodies should be saddled with the whole panoply of government administrative procedure of the type imposed upon agencies of the federal government under the Administrative Procedure Act. I doubt

^{25/} Advisory Committee Report, supra n. 10, at pp. 2 and 16.

if it would be suitable for non-governmental organizations, and furthermore, based on my experience as a government official for many years and as a member of the Administrative Conference of the United States, I have concluded that the imposition of government administrative procedure is not without serious problems, including delay, cumbersome formalities, and unnecessary expense for all concerned.

4. What do you consider the appropriate legal and operational relationship between the self-regulatory agencies and the SEC? What are your views on the SEC proposals, embodied in H.R. 15303, with regard to the SEC's authority over actions of the self-regulatory agencies?

The Subcommittee's final question requests my views on the appropriate legal and operational relationship between the self-regulatory agencies and the Commission.

The Congress recognized that there were practical limitations associated with a completely federalized regulation program which could render it inefficient and self-defeating, given the highly complex and dynamic nature of this industry.^{26/} Thus, it was determined that the best approach would be self-regulation by the industry itself. The concept of self-regulation which evolved was a balanced pattern of industry-government cooperation and partnership. The industry was to regulate itself to the greatest extent possible, subject to the public oversight function performed by the Commission. Governmental power was to be held in reserve as a safeguard to ensure that the industry adequately

^{26/} See Hearing on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934) at 514.

performed its self-regulatory role in a manner not inimical to the public interest. In 1938, Mr. Justice Douglas, then Chairman of the Commission, defined the relationship between the self-regulatory organizations and the Commission as one of "'letting the exchanges take the leadership with Government playing a residual role.'" ^{27/}

Since the Congress vested much autonomy and responsibility in the various self-regulatory organizations, they have been permitted to exercise their delegated authority to implement regulatory programs tailored to suit the operational circumstance of each marketplace. The Commission's oversight function of self-regulatory activities has been exercised in the public interest and for the protection of investors to ensure that the power and authority which have been delegated to the self-regulatory bodies are not

^{27/} Special Study, supra n. 13, pt. 4 at p. 698.

abused or used to accomplish purposes inimical to the public interest as well as to insure that there is no gap between self-regulatory needs and actual self-regulatory performance.^{28/}

The Commission believes, as I have already said, that self-regulation should be preserved. At the same time, one of the essential decisions made by the Congress in 1934, when it determined to establish governmental supervision and oversight over the existing self-regulatory activity of the exchanges, was that public policy demands that private bodies exercising what essentially are governmental powers should be subject to adequate public supervision through a governmental agency. That decision was sound then, and it is sound now. The changes which I have referred to in the very nature of the

^{28/} As Mr. Justice Goldberg stated in the Silver case, "the initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain with the exchanges themselves. It is only where they fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so." Silver v. New York Stock Exchange, 373 U.S. 341, 352 (1963).

responsibilities and functions of the self-regulatory agencies call for a reexamination of the somewhat uncoordinated pattern of oversight which was provided in various statutes enacted primarily between 1934 and 1940. They further call, in my opinion, for a strengthening of the Commission's oversight authority by reason of some of the problems which I have referred to above.

Deficiencies in the statutory pattern of oversight have been discussed for many years. The Special Study of 1963 described them at length; they were given careful attention by the Supreme Court of the United States in the Silver case;^{29/} and more recently, they were examined in the Commission's Study of Unsafe and Unsound Practices of Brokers and Dealers,^{30/} sent to the Congress in 1971. I will not attempt to go through this background.

Self-regulation, if it is to function properly, should not be stifled nor should the initiative of self-regulatory agencies be dampened by too detailed government supervision.

^{29/} See n. 28, supra.

^{30/} H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971).

On the other hand, public interest requires that the Commission's residual powers must in fact exist and be clearly delineated so as to insure to the extent possible that the self-regulatory bodies perform their functions in a diligent and vigorous manner. At the same time, the Commission should have a clear mandate from the Congress to empower it to interpose its authority directly, if and when the self-regulatory organizations fail to meet their regulatory responsibilities in the public interest and for the protection of investors. Ideally, as Mr. Justice Douglas (then Chairman of the Commission) stated in 1938, the "[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use, but with the hope that it would never have to be used."^{31/} Nevertheless, it appears evident that in order for the Commission to exercise its "supplementary powers of direct regulation,"^{32/} it must first be vested with such powers by the Congress. Accordingly,

^{31/} Special Study, supra n. 13, pt. 4 at p. 698.

^{32/} S. Rep. No. 1455, 75th Cong., 3d Sess. (1938) at 3-4.

I believe the proposals embodied in H.R. 15303 merit your careful consideration and ultimate approval. We have submitted to the Congress detailed explanations and justifications for this legislation, and I will not attempt to repeat them here.

In conclusion, self-regulation is, I believe, a valuable and probably necessary component in the regulation of this large, diverse, exceedingly complex and very important industry. Such self-regulation must be adapted as rapidly as possible to the changing needs and problems of today and of the future. Commission oversight over this self-regulatory process, which Congress also found essential, must be retained and adapted to present conditions, which I think means that it should be strengthened. Ever since 1934, any proposal to grant power to the Commission has been met with the objection that such power could be used

with a reckless disregard for the underlying purposes of the Congress.^{33/} I think the record over the years demonstrates that this concern is unfounded. I am sure the Commission retains a healthy respect for the governing principles underlying the philosophy of self-regulation written into the Securities Exchange Act. And, as always, the fidelity of an administrative agency to the legislative aims of Congress is subject to continuing Congressional oversight.

^{33/} For example, when it was proposed that the Commission be given jurisdiction over exchange commission rates, it was objected that it might set the rates "so low that no broker could stay in business." 78th Cong. Rec. 8091 (1934).

American Stock Exchange Inc.

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H Vernon Lee Jr
Vice President
Membership Services Division

September 25, 1972

Mr. G. Bradford Cook, Director
Division of Market Regulation
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Dear Mr. Cook:

Enclosed for filing pursuant to Exchange Act Rule 17a-8 are three copies of a proposed Statement of Policy on publication of rule and policy proposals which has been approved in principle by the Board of Governors of the American Stock Exchange to provide its members and other interested parties an opportunity to review and comment on proposed major rule and policy proposals before their final adoption by the Board.

It is proposed that under this policy the Exchange will, when practical, publicize rule proposals and major policy matters before the Exchange formulates a definite position on them and invite interested parties to submit written comments. In appropriate instances, opportunity also will be given for oral presentations. A summary of the comments received will be furnished to the Board before any final action is taken on the particular rule or policy matter.

It should be noted that the proposed Statement of Policy does not state the precise method by which rule or policy proposals will be publicized. It is expected that the exact procedure to be used will vary according to the nature of the matter and the circumstances. Furthermore,

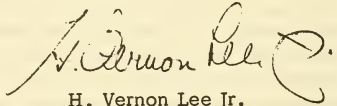
Mr. G. Bradford Cook, Director
Securities and Exchange Commission

September 25, 1972

in order to give the Exchange sufficient flexibility to adopt a rule or policy change promptly where necessary, the proposed Statement of Policy provides that failure to follow the procedures for the publicizing of rule proposals will not affect the validity of any action taken by the Exchange.

If you have any questions regarding this proposed Statement of Policy, please do not hesitate to call me or Peter J. Armstrong, Assistant Secretary of the Exchange.

Very truly yours,

A handwritten signature in dark ink, appearing to read "H. Vernon Lee Jr.", with a large, stylized flourish at the end.

H. Vernon Lee Jr.
Vice President

Statement of Policy on
Publication of Rule and Policy Proposals

It shall be the general policy of the Exchange to publicize proposals to adopt new rules or to amend or rescind existing rules before the Board of Governors takes final action with respect to such proposals. Similarly, major policy matters affecting the Exchange, its membership, listed companies, or public investors, will, when practical, be publicized before the Exchange formulates a definitive position with respect thereto.

The Exchange will in each instance publicize such rule proposals or policy matters in a manner designed to give interested parties reasonable notice thereof and an opportunity to comment thereon. The notice shall generally describe the subjects and issues involved and, where appropriate, may include the text of the proposed rule or policy position. Interested parties will be invited to submit comments and supporting documents to the Exchange in writing. In appropriate situations, opportunity may also be provided for oral presentations. A summary of the comments received shall be furnished to the Board of Governors before it takes final action with respect to the particular rule proposal or policy matter.

Nothing in this Statement of Policy shall be construed as limiting or restricting the Board in any way in exercising the powers vested in it under the Constitution. The Board may take action at any time to adopt, amend or rescind any rule, policy or directive without following the above procedures if it shall deem such action to be appropriate and in the best interests of the Exchange and its membership. Failure to follow the above procedures in any specific instance shall not affect the validity, force or effect of any rule, policy or directive adopted by the Board or of any Exchange action or omission to act thereunder.

STATEMENT OF
GORDON S. MACKLIN, PRESIDENT
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

We are appreciative of this opportunity to appear at the

Subcommittee's last hearing relative to its study of the securities industry. We are mindful that analysis and study of the varied views and the numerous documents so far presented to the Subcommittee is still required and as a result we do not believe it necessary to unduly burden the Subcommittee with a lengthy recitation of our previous statements or positions. Instead, we will attempt to answer the specific questions raised by Senator Williams in his invitation to appear today.

As a preface to my comments I would like to emphasize my belief that the securities industry after withstanding tremendous pressures and problems now stands ready to accept and implement constructive recommendations for change. The changes which will be most salutary relate to (1) elimination of duplication of regulation, (2) strengthening of the competitive aspects of trading markets, and (3) utilization of available technology to make markets more accessible to investors and broker/dealers, as an aid to execution and clearance of transactions. We look forward to the completion of the study and to participating in the revitalization of the structure of the industry.

SUBCOMMITTEE QUESTIONS

1. Authority of Self-Regulatory Organizations

Authority among the self-regulatory agencies, as well as among the state and federal regulators, has been pervasive, expensive,

and much duplicated. Throughout the years we have demonstrated our willingness to cooperate and coordinate with other authorities in our effort to eliminate costly duplication.

In certain areas, regulation is related only to the market place involved. For example, exchanges only are concerned with floor trading rules, while the NASD is not, having no physical trading "floor". On the other hand, only the NASD is concerned with regulating markups on principal transactions with customers, or in "free-riding" in connection with distribution of new issues, matters in which exchange markets are not involved. Recent events have led to changes in enforcement of capital rules. Previously, capital regulation was divided between exchanges and the NASD but under a recent rule of the Commission each agency is required to notify the other when a dual member's capital is in doubt.

Additional areas exist for cooperation and we intend to explore with all other self-regulatory bodies the possible use of Association examination facilities throughout the nation on a cost sharing basis. Currently, we maintain 14 district offices staffed with experienced personnel who could be used in those areas where exchanges do not maintain offices. NASDAQ, to which I will refer in more detail later, provides us with the means to keep all securities in the System under continuous surveillance, and we have and are willing to share this information with other regulatory bodies.

Last year National Clearing Corporation, an NASD subsidiary, completed conversion of New York City firms from the balance order to the continuous net system for clearing over-the-counter transactions. As time passes and the new system is operative nationwide, financial information can be gathered which can be of material assistance in monitoring the changing financial condition of individual members on a daily basis.

It has been suggested that authority between self-regulatory agencies be divided by function. As we understand it, the Association would be delegated responsibility for those functions relating to qualifications for entry into the business and inspection of the operation of those in the industry for compliance with applicable rules and regulations. The exchanges, on the other hand, would regulate trading which takes place within the exchange. This idea has merit since it would eliminate certain duplications. However, it seems premature to make a judgement as to such a division since we are not aware of exchange views in this area and also because the details of the suggestions cannot be known until a design for a central market system has been achieved.

We welcome suggestion and the opportunity to cooperate with the other agencies in expanding and making more efficient our joint efforts.

2. Composition of Governing Boards of Self-Regulatory Organizations

The composition of governing boards of the self-regulatory agencies has been an active subject of consideration in recent months in

view of the major changes taking place on boards of the exchanges. Little has been said, outside the Association, as to the composition of its Board although we have addressed this problem.

Recent By-law changes have provided for expansion of our Board from 24 to 27 members. The additional three positions are to be filled by "governors-at-large" who need not be selected from within the securities industry as are other governors. While this may seem to be a relatively small number of non-industry or "outside" governors in contrast to the recent changes in exchange Board composition, any evaluation must give due consideration to the differences in make-up of the membership of exchanges and securities associations.

Exchanges are limited in membership and have fixed commission rates, whereas there is unlimited membership in a securities association with a statutory prohibition against fixed rates, fees or charges. In addition, the Maloney Act contains specific provisions requiring fair representation of members in the adoption of any rules or in selection of officers or governors and in all other phases of the administration of Association affairs. In addition, before registering a securities association under the Act, it must appear to the SEC, considering the number of Association members and the scope of their transactions and geographic distribution, that the purpose of the Securities Exchange Act of 1934 will be carried out. Association By-laws, which spell out the manner of selection

and geographic allocation of governors must be filed with and not disapproved by the SEC. Similar requirements are not applicable to exchanges and thus the concept of a large public or outside Board representation for exchanges, as recommended in the Martin Report to the New York Stock Exchange, is not appropriate for a Maloney Act association.

Our recent provisions for addition of outside governors does show recognition of the many benefits to be derived from having independent Association Board members, having a different breadth of experience, and who are available to mold, influence and reach healthy, long range solutions to industry problems.

We believe we have been extremely fortunate in our quest to add impartial, highly experienced and knowledgeable outside persons to our Board. Recently, Dr. James H. Lorie, Professor of Business Administration at the University of Chicago School of Business Administration agreed to join our Board.

In addition, only last week we learned that A. A. Sommer, Jr., Esq. of Calfee, Halter, Calfee and Sommer of Cleveland, a leading member of the Bar, and Chairman of the American Bar Association Committee on Federal Regulation of Securities, has agreed to serve as a governor-at-large.

We are gratified that these distinguished persons have accepted these posts. Their impact will, I am sure, be of great significance and we commend them on their willingness to participate in the forthcoming decisions of the Association, particularly as they affect the restructuring and establishment of a "central market" system.

Association Board members have been drawn from the industry under the philosophy of "self-regulation" as contemplated under the Exchange Act so as to use the expertise of industry members to foster improved and enlightened regulation in all phases of a most complex industry. The basic work of the Association was conceived to be regulation of members through inspection and discipline, formulation of new rules and policies, and accomplishment of these tasks by those having the judgement and experience which can be provided only by those with long experience in industry practices.

At any given time more than 300 individuals will be serving on one or more of the various Committees of the Association. District Committees responsible for business conduct of members in their particular geographic areas serve for three years, as do members of the Board of Governors. Selection of candidates is accomplished by nominating committees in accordance with procedures set forth in the By-laws. The Board serves as an appeal and review body for district

disciplinary actions and sets national policies, including formulation of new rules which must be voted upon by the members. As a result there is a constant regulatory educational process in existence, with outgoing Committee and Board members taking their regulatory experience back to the industry. Thousands of persons with this experience now populate the industry. This I believe to be a most important factor in self-regulation and should be encouraged since it results in inculcation of high standards of business practice, which was intended by the Maloney Act.

I do not wish to imply that no criticism has been leveled at the composition of the Association's Board of Governors. This has usually consisted of charges that the Board is dominated by individuals who are associated with exchange member firms. As we indicated to the Subcommittee in a prior session, while individual Association board members from firms also having exchange memberships have played a major role in Association activity, we do not believe their influence or decisions have reflected any bias favoring exchanges or their policies over the market they are charged to regulate. The Association's implementation of its NASDAQ system and creation of National Clearing Corporation stand as examples of progress although each of these necessary systems can be considered competitive to exchange trading and clearing systems. We continue to think that the original premise of the use of

industry members to bring to bear their experience in areas only they fully comprehend, is desirable. This, coupled with inclusion of informed members from without the industry bringing to bear an independent, unbiased viewpoint, will be the proper approach to long range solutions. Almost needless to say, we believe the public interest has been, and will continue to be, served by our Board, functioning under the Maloney Act, with the cooperative oversight of the SEC and Congress.

3. Procedures of Self-Regulatory Organizations

In 1970 new procedures for adopting Association rules were instituted under which for the first time proposed rules are distributed for comment to the membership, the press, and others, prior to adoption by the Board. The procedure has been well received and invaluable comments from our members, the Bar and other interested parties have resulted. We intend to continue this practice and, where feasible, to expand upon it in an attempt to draw meaningful suggestions from those experienced in the areas under consideration.

Recently, the Securities and Exchange Commission requested that the Association adopt rules or guidelines covering members' practices relating to new "hot" issues (those which have an immediate and dramatic increase in price on the day of their offering). Upon receipt of this request, the Board appointed a Committee which is unique for us in that it consists of outside advisers who are highly experienced in law and accounting, as well

a group of leading industry experts. This Committee is currently working to formulate detailed recommendations to the Board, and we suspect that their success will lead us to supplementing future committees with outside advisers possessing appropriate expertise.

We make no suggestions concerning the Association's procedures in disciplinary proceedings. As the Committee is aware, these procedures are mandated by the Maloney Act. Respondents have always been permitted representation by counsel or to whatever assistance they believe necessary in their response to Association complaints. A written record is made and full right of appeal exists initially to the Securities and Exchange Commission and ultimately to the courts, under the statute. We believe the system has functioned as contemplated by the Congress, and perhaps with certain minor modifications, such as permitting the SEC, on review, to increase penalties, any changes are not now indicated. It appears in the interest of fairness that uniformity among self-regulatory organizations is desirable and we would support such legislation.

4. Relationship of Self-Regulatory Organizations and SEC

The legal and operational relationship existing between the Association and the Commission has, in our opinion, been beneficial, and has resulted in the cooperative regulation which the statute envisaged.

Presently, the Act does not permit the SEC to increase penalties imposed against Association members in cases on appeal to the SEC. We think the Commission should have such power. We do not believe that the provisions contained in H. R. 15303, requiring that disciplinary matters before the Commission be remanded to a self-regulatory association for further review and imposition of different or additional penalties, to be desirable. Our experience with hundreds of cases on appeal to the Commission indicates that there are extremely infrequent instances where an additional or different penalty should have been imposed, and there appears to be no reason why the Commission should not, after a complete review on the record, be permitted to assess an appropriate penalty. Additional power, as provided in H. R. 15303, to be vested in the Commission which would permit it to enforce the rules of a self-regulatory organization directly may be desirable, but we have not seen, nor do we believe the record will indicate, that past Association enforcement in respect to its own rules was lacking.

NASDAQ/NCC

The following remarks are included with this statement in recognition of the Subcommittee's continuing and constructive interest in the NASDAQ system and the National Clearing Corporation.

The NASDAQ system represents an investment of approximately \$25 million by The Bunker-Ramo Corporation, the system operator, in addition

to the years of time and effort invested by various people affiliated with the NASD. NASDAQ commenced operation on February 8, 1971. At that time, 2,300 securities were quoted in the system and the computers were handling about 250,000 calls per day. Today, there are in excess of 3,400 securities being quoted, and the average number of calls per day is about 1,250,000. Daily trading volume recorded through NASDAQ on most days is well in excess of twice the total volume on the American Stock Exchange and, in fact, exceeds the combined total volume on all exchanges in the country except the New York Stock Exchange. Future plans for the system include the implementation of a trade reporting program and eventually a direct linking of the data from this program with the clearing operation of the National Clearing Corporation.

The National Clearing Corporation has been operating in New York City since October 15, 1971, using a continuous net method of settling over-the-counter transactions. Recently, pilot operations were implemented to include Boston and Philadelphia through the facilities of the regional stock exchanges in those cities. These pilot operations are currently being expanded. Recent discussions with the Midwest Stock Exchange have indicated that the National Clearing Corporation will be operating in Chicago through the facilities of the Midwest Stock Exchange Clearing Corporation before the end of this year. We plan to commence operations in a number of additional key cities throughout the country and hope to be operating on the West Coast through the facilities of the Pacific Coast

Stock Exchange before the end of next year. It is important to note, however, that even at this early stage the National Clearing Corporation is handling approximately 10,000 - 15,000 trades per day and, thus, is the second largest stock clearing organization in the country. Our goal is to process 35,000 - 50,000 trades when the system is expanded to cover all national trading areas in the country.

The NASDAQ system design has created for the Association an entry into market surveillance via regulatory reports which are produced in a NASDAQ issue whenever it exceeds certain predetermined price or volume parameters. Many of these parameter breaks are obviously routine instances of price and volume fluctuation. However, the staff of the Association's new stock watch department established for the purpose of reviewing and detecting possible manipulation, has of the 487 cases it investigated since its establishment in January 1972, referred 13 to the SEC for further investigation of possible violations of the Federal securities laws and 6 to the Association Districts for investigation of potential violation of the Association's rules. This material, coupled with reports generated by the National Clearing Corporation as to dealer trading activity and capital and operational condition, substantially improves our ability to effectively regulate activity in the over-the-counter market.

In sum, we feel that we are progressing rapidly along the road toward a well regulated and highly automated over-the-counter market with access open to all qualified dealers. Needless to say, we greatly appreciate the help we have received with these programs from Congress and the Securities and Exchange Commission.

Statement of Paul Kolton, President
American Stock Exchange, Inc.

My name is Paul Kolton. I am President of the American Stock Exchange. With me today is Norman S. Poser, Senior Vice President for Policy Planning and Government Relations.

The Amex welcomes this opportunity to express its views to the Subcommittee concerning self-regulation in the securities industry and to respond to the questions regarding the regulatory process which were posed by the Subcommittee.

Much has been said and written about the unique system of self-regulation under which the securities industry operates. Most of the authorities and commentators, including the SEC in its 1963 Special Study and the House Subcommittee on Commerce and Finance in its recent Study Report, have endorsed the concept of self-regulation, while criticizing certain aspects of its operation.

The reasons for preferring a self-regulatory system, with continuing government oversight, over a system of direct governmental regulation are, we believe, as valid today as when the system was established in the 1930's. These reasons include the advantage of expertise and closeness to the markets and the industry which self-regulators have; the ability to enforce ethical standards which go well beyond purely legal standards of conduct; the fact that continual involvement of industry members in the regulatory process makes them more responsive to tough-minded self-discipline and to developing higher standards of conduct; the recognition that industry, and not government, should bear the cost of the regulatory burden; and, as one of the original framers of the securities laws stated at the time

of their passage--the alternative to self-regulation, as a practical matter, brings with it "the sheer ineffectiveness of attempting to exercise [regulation] directly through government on a wide scale."

We believe that self-regulation is the most effective system available for protecting public investors and safeguarding the public interest. It is, to be sure, an imperfect and sometimes untidy system; but in the perspective of the years it has enabled the securities business--and the millions of people it serves--to make a singular contribution to the success of the nation's economic system.

An effective self-regulatory mechanism requires a delicate balance in the exercise of government power. On the one hand there is the natural tendency to wield government power directly--and over time this will inevitably undermine the self-regulatory process. On the other hand, there is the risk that failure by government to oversee and coordinate the activities of the self-regulatory organizations will impair public confidence in the markets.

Both extremes must be avoided, and we believe, with some concern, that the trend today, even on the part of many who endorse self-regulation, is to introduce direct government control into the self-regulatory mechanism. There is a danger in this development that if the SEC is given more direct administrative responsibility in the operation and regulation of the markets, self-regulation will become more a matter of form than of substance. I believe that it is vitally important

that Congress and the SEC realize, in their efforts to correct past problems and to create the securities markets of the future, that the self-regulators need to retain sufficient latitude to encourage initiative and to discharge their regulatory tasks boldly. We approach the questions which were posed by the Subcommittee with these thoughts uppermost in our minds.

1. What suggestions, if any, would you make for reallocating authority among the various self-regulatory agencies? Over which firms, and which activities, should each of such agencies exercise effective authority?

Since many broker-dealers, including most of the larger firms, are members of several exchanges as well as the NASD, a certain amount of overlapping of functions and responsibilities among the self-regulatory organizations is inevitable. Nevertheless, in view of the fact that major investigative and enforcement actions are likely to involve a variety of member-firm activities, it is important that the self-regulatory organizations retain broad authority to take necessary action in any aspect of a member firm's business. For example, an investigation by an exchange that begins as an inquiry into a trading situation may lead to questions being raised involving a firm's underwriting activities, its handling of customer accounts, its supervisory procedures, or other aspects of its business.

We would, therefore, not recommend at the present time that the scope of authority and responsibility of the self-regulatory organizations

be restricted or compartmentalized to particular types of activities or functions, even though, theoretically, there may be some potential overlap. Such duplication has been reduced materially through arrangements among the self-regulatory organizations for the allocation of regulatory authority and for joint reporting of critical information. For example, duplication has been virtually eliminated in such areas as member firm examinations and screening of the background of applicants for membership or registration as salesmen. By and large these allocation arrangements have worked efficiently. While problems have arisen from time to time in coordinating the flow of information among the self-regulatory organizations, such problems have been dealt with effectively once they have been identified. We are continuing to develop procedures for more effective coordination with other self-regulatory organizations and the SEC; and we are confident that further improvements will be made in this area.

Looking to the future, the establishment of a central market system will clearly provide an opportunity to assess, in a current setting, the present arrangements for allocation of authority. Pending the development of the system, whose specific shape we do not yet know, we think it premature to make any specific suggestions for the reallocation of authority among the self-regulatory organizations.

2. What rules should apply to the composition of the governing boards of the self-regulatory agencies, and to the manner of selecting members of those boards?

During the past several months, a number of the self-regulatory

organizations have, on their own initiative, taken major steps to reorganize their governing structure and provide substantially more public representation. Last June, the membership of the Amex approved a restructuring of its Board of Governors which is perhaps the most important change of its kind in the 125-year history of the Exchange.

This reorganization, which follows the basic principles enunciated in the 1971 Martin Report, calls for a Board with half of its members coming from the public sector. Earlier this week, the Exchange's Nominating Committee, which itself has 50 percent public representation, announced the names of its nominees; among those proposed for the 10 public governors are a group of distinguished lawyers, economists, educators, business executives, and representatives of the media. It should be emphasized that this significant reorganization was neither prompted by nor imposed by an agency of the government. Rather, it was designed and implemented independently by the membership in recognition of the Exchange's expanded public role and responsibility.

These major changes, which are as a practical matter irreversible, must be tested in operation over time. As experience is gained under the restructured system, the Exchange would expect to make any adjustments which may appear desirable. But in view of the steps already taken by the Amex, and by other self-regulatory organizations, we do not believe that either specific SEC rules or legislation is required.

3. What suggestions, if any, would you make for improving the procedures followed by the self-regulatory agencies in adopting rules and policies, and in conducting disciplinary proceedings?

The Amex has continually explored ways in which the self-regulatory procedures can be made as responsive as possible to the needs of the public, the firms and the companies which it serves. The restructuring of the Board, mentioned a moment ago, is a part of this process. Even before the reorganization, however, it was recognized that it would be necessary to develop and formalize a procedure to permit members of the investing public to comment on all major proposed rule and policy changes.

The Amex Board of Governors, therefore, last month approved in principle and filed with the SEC a proposed policy under which the Exchange will publicize proposals to adopt new rules, or to amend or rescind existing rules, before the Board takes any final action with respect to such proposals. Similarly, major policy matters affecting the Exchange, its membership, listed companies or public investors will be published, comment sought, and hearings held, where required, before the Exchange takes a definitive position.

This decision by the Exchange to give interested parties an opportunity to comment on rule proposals and policy matters constitutes another step by the Exchange to remain responsive. We believe that these procedures will also assist the SEC in fulfilling its own responsibilities to review proposed self-regulatory rules and policies and in gaining additional insight into their public impact.

With respect to the conduct of disciplinary proceedings, the Amex Board of Governors has also recently approved a series of far-reaching charges which will streamline procedures in the light of present needs and will afford respondents increased "due process" protections: in particular, those accused will have the right to counsel, and cases will be heard by three- or five-man hearing panels. It is expected that the revised procedures will be submitted to the Exchange membership for approval later this month.

4. What do you consider the appropriate legal and operational relationship between the self-regulatory agencies and the SEC? What are your views on the SEC proposals, embodied in H.R. 15303, with regard to the SEC's authority over actions of the self-regulatory agencies?

The Exchange administration is pleased to comment on these questions, although they have not been discussed with the Amex Board of Governors and do not reflect the Board's views. In the event that the proposed legislation is introduced in the Senate, we would appreciate the opportunity to offer the Subcommittee our detailed comments.

We concur with the SEC's view, which it stated in its report of last December on "Unsafe and Unsound Practices of Brokers and Dealers," that it is essential that the SEC be deeply involved as an overseer of the self-regulatory process. At the same time, we think that the self-regulatory organizations should retain sufficient independence to enable them to exercise their initiative--vigorously and

broadly when that is required--on regulatory matters within their authority.

We believe it is entirely appropriate for the SEC to have the power to require the self-regulatory organizations to adopt, amend, or rescind their rules which affect the public interest. Furthermore, we agree that the procedures for exercising such authority should be simplified and clarified. We also believe it is appropriate for the SEC to review Exchange disciplinary actions and other particular applications of Exchange rules.

We do not believe it would be in the public interest, however, to give the SEC authority to enforce Exchange rules or to increase penalties in Exchange disciplinary actions. That would appear to us to be a step that, over time, would debilitate the self-regulatory process, and the people charged with administering it. There is, of course, the ancient question--without such power, can the SEC properly protect the public interest? The fact is that most serious violations of Exchange rules which might make direct action against an Exchange member by the Commission appropriate would be matters that are also within the existing statutory authority of the Commission. However, the ability of an exchange to compel compliance with ethical standards would be impaired by such direct use of governmental power. Therefore, possible marginal benefits

which might come about as a result of SEC authority to enforce Exchange rules would be substantially outweighed by the significant damage which would be done to the self-regulatory system.

As we indicated earlier, among the advantages of this system are the closeness to the scene of the self-regulatory organizations and the speed with which they are able to act. Bringing the SEC's direct authority into this arena, either by direct enforcement of Exchange rules or by the ability to impose additional penalties in Exchange enforcement actions, would have to reduce seriously the effectiveness of the self-regulatory system. Such an expansion of the SEC's authority would be likely to enmesh the Commission and the self-regulatory organizations in procedural, legal and interpretative problems and greatly diminish the speed and effectiveness with which the self-regulatory agencies can act.

STATEMENT OF THE
MIDWEST STOCK EXCHANGE, INCORPORATED

TO THE

SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

FILED
OCTOBER 3, 1972

I am Michael E. Tobin, the President of Midwest Stock Exchange, Incorporated. We welcome this further opportunity to discuss the very important subject of regulation and self-regulation of the securities markets and of the securities business.

Although the structure of the securities markets and of the industry is obviously in the process of great change, and one of the most important changes undoubtedly will be in the direction of greater competition in the performance of many functions, we do not share the view that greater competition will dispense with the need for strong regulatory and self-regulatory systems. Greater emphasis on competition undoubtedly will modify the regulatory need to one degree or another in various places, but in our judgment there will always remain very important areas where regulation will be essential to assure basic standards, to assure fair field of competition, or simply to deal with subject matters not particularly touched by competition.

At the same time, even though we feel certain that the regulatory system will continue to be of great importance in a restructured market

system, we think it is probably premature to try to define the shape of future self-regulation or cooperative regulation until the future structure becomes somewhat clearer.

By way of illustration, in the 1934 Act, self-regulation is based on membership in separate exchanges; and membership is defined in terms of economic differences with respect to commission rates. We are in a period of new and still very fluid concepts concerning relationships of markets to each other, commission rates and access, the role of competition in relation to regulation, the number and types of member firms, the role of automation, and other matters. Since the allocation of regulatory responsibilities obviously must be adapted to the operational realities of the securities markets and securities industry, it will be much easier to come to a sensible allocation after there has been further crystallization in some of the areas mentioned.

Although there is undoubtedly room for better coordination and possibly for some consolidation, we believe it is essential to stop far short of relying on any single, monopolistic self-regulator, or even two self-regulators dividing the field. For many reasons, we believe that competition among a number of market makers, market centers and market regulators is greatly preferable to any monolithic approach. Even if concentration in a single agency or two would provide greater short-term economy, in the long run it would be at the expense of dynamism and progress.

There is another reason why we doubt the advisability of thinking in terms of just two regulatory agencies, one dealing with markets and the other with firms, as some are apparently suggesting. Between internal market regulation on the one hand and financial regulation of member firms on the other hand, there is a wide gamut of other regulatory activities;

and this may become wider as member firms expand the scope of their operations into new fields. For example, to the extent that there is a self-regulatory obligation relating to an activity that is not conducted within a securities market in the normal sense -- e.g., commodities, insurance, real estate syndication -- it is not clear that the self-regulatory arm of any particular market or market center is in a better position than another to engage in the necessary regulation. It is even less clear that any single agency, except one of enormous size and power and elaborately structured on a regional and/or functional basis, could be expected to cope effectively with the multiplicity of regulatory needs. The securities industry involves a great number and variety of activities conducted in many different combinations by a large number of firms. It does not conform to any neat, symmetrical pattern, and such pattern as there is is constantly changing. Instead of attempting to concentrate self-regulation of this pluralistic and dynamic business in a single, highly structured agency, it seems to us that the total regulatory job can best be accomplished through a looser, more pragmatic system of separate but coordinated agencies.

Of course, whatever re-allocation of regulatory responsibilities may occur, it is obviously desirable to avoid unnecessary duplication of regulation, which is costly and burdensome to regulators as well as to those regulated.

As to the procedures of the Commission and the self-regulators, we may have some comments in a fuller statement which we expect to file at the conclusion of these Hearings. For the present we would simply say that there is too great a variety of regulatory activities to fit everything into a single procedural mold. Procedures should be flexible and adaptable, so that different types of matters can be handled appropriately in light of their novelty, complexity, importance and impact on others.

I would like to conclude with a few more specific comments on the position of the Commission in the regulatory scheme. In general, we feel that the Commission's supervisory jurisdiction ought to be as broad as the self-regulatory obligations of each agency. Alternatively, if the Commission's authority is not as broad as the agencies' responsibility, then the law ought to make clear that, even without Commission review, there is an antitrust exemption for action taken in good faith to achieve a self-regulatory purpose.

In performing its oversight role, the Commission should attempt to speak as unambiguously as possible as to what it is requiring, approving, accepting, or not passing on. Further, to the extent possible, the Commission should acknowledge changes and refinements in its policies and procedures as they are in the process of development. In our judgment, greater certainty on the part of self-regulators with respect to the position of the Commission in those areas in which it exercises jurisdiction cannot but be helpful in achieving common regulatory objectives.

Whether the term "self-regulation" or the term "cooperative regulation" be used, the self-regulators should be encouraged to be responsible, dynamic participants or partners in the process, and not mere instruments of the Commission. While, as suggested above, Commission oversight should ordinarily be as broad as self-regulatory responsibility, there should continue to be ample scope for self-regulators to take the initiative and exercise independent responsibility without undue Commission intervention. We would, therefore, generally favor the expansion of the Commission's supervisory role as proposed in H. R. 15303, on the assumption that the Commission will continue this general approach of leaving initiative and responsibility to the self-regulators to the greatest possible extent. However, we have some doubt as to the appropriateness of the procedure that is proposed with respect to amendment of the rules of an exchange under Section 9 of the bill (amending Section 19(b) of the Securities Exchange Act of 1934) whereby the Commission would act by rule under Section 553 of Title 5 of the United States Code without the necessity of a hearing "on a record". We reserve the right to make further comment on this and other aspects of H. R. 15303 in our fuller statement at the conclusion of these Hearings.

STATEMENT OF DONALD L. CALVIN, VICE PRESIDENT, NEW
YORK STOCK EXCHANGE, INC., BEFORE THE SUBCOMMITTEE
ON SECURITIES OF THE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS, UNITED STATES SENATE

October 5, 1972

My name is Donald L. Calvin. I am a Vice President of the New York Stock Exchange, Inc.

I appreciate this opportunity to comment on four questions dealing with securities industry self-regulation, posed by Chairman Williams in his letter to us of September 21, 1972.

First, however, I would like to note that the long series of hearings which have occupied this Subcommittee and other Committees of Congress over the past 18 months have not merely identified and explored various problem areas in the securities industry. They have, as well, provided valuable guidance as to where constructive changes may be needed.

The industry, for its part, has not been sitting back complacently. We have been making important changes --both structural and operational-- and we have been preparing the way for more far-reaching changes in the basic ways in which this industry functions. We believe that there is an urgent need to forge changes in the existing regulatory scheme so that it may genuinely reflect a concept of "cooperative regulation" in which the Congress, the Securities and Exchange Commission and the industry itself each has a meaningful role.

We are hopeful that the Congress will also pursue this goal in developing legislative guidelines which will shape the future of the securities industry in America.

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As requested, I will comment very briefly on the four specific questions raised in Chairman Williams' letter of September 21.

The first of these questions deals with the Possible Re-Allocation of Self-Regulatory Authority. We assume that the Subcommittee seeks our views as to whether the existing self-regulatory mechanism should be restructured. This question could be construed to include a number of suggestions, among them the idea that one self-regulatory entity might be authorized to oversee the operations and capital requirements of securities firms, while another would oversee trading and markets.

The question of the Legal and Operating Relationships Between the SEC and the Exchanges and the invitation to comment on H.R. 15303, the bill introduced in the House of Representatives by Representative Staggers, would seem to be closely related to the question of re-allocating self-regulatory authority.

Both of these questions are, of course, of crucial long-range importance to the New York Stock Exchange. Our new Board of Directors, which, as you know, has been in office only three months, has not yet had adequate opportunity to study them or formulate Exchange policy in either area.

I think it is pertinent to note, however, that as the securities industry approaches the goal of a central exchange system --a goal to which I believe all of us are committed-- we will be in a better position to determine whether or not it may be desirable to make specific changes in the structure of the existing self-regulatory apparatus and in the existing relationships between the self-regulatory organizations and the SEC.

In any event, I want to assure the Subcommittee that we will be happy to supplement this statement with a clear statement of the Exchange's views on both of these important issues as soon as our Board has formulated its positions.

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Turning to the Governing Boards of Self-Regulatory Organizations, the Subcommittee is, of course, aware that the NYSE earlier this year completed a precedent-shattering reorganization of its governing structure.

Our objective in restructuring the Exchange's policy-making body was two-fold: to reflect the fact that the interests of the Exchange are closely related to those of the public; and to provide for an increased concentration of leadership in the Exchange's governing structure. We believe that the recent reorganization fulfills that objective.

The reorganization of the Board stemmed from a report submitted

to the Exchange in December 1971 by a special committee headed by Cornelius W. Owens, a public member of the previous Board who has also been elected to the new Board. That report was based on an earlier one by William McChesney Martin, Jr., in August 1971, which was made at the Exchange's request.

Prior to July 1972, the NYSE Board consisted of 29 Governors from within the securities industry, 3 Public Governors and the President of the Exchange. The new Board is composed of 10 Industry Directors, 10 Public Directors and a full-time salaried Chairman who is also the Exchange's Chief Executive Officer. The creation of the office of full-time Chairman establishes a greater focus of responsibility than existed under the previous structure where leadership was shared by an unpaid Chairman, elected from the Exchange membership and concerned primarily with policy matters, and a full-time salaried President chosen by the Board as Chief Executive Officer.

The reorganization provides that the 10 Industry Directors must be principal executives of their member firms, and that the Public Directors should reflect a broad spectrum of public interest in addition to having achieved eminence in their respective fields outside the securities industry.

Attached to this statement, as Exhibit A, is an article from the August 1972 issue of The Exchange magazine which includes brief biographical sketches of all 21 members of the new Board of Directors.

We believe that the Exchange is indeed fortunate to have been able to attract a new Board of outstanding qualifications and caliber. In its first three months in office, this Board has demonstrated an extraordinary commitment and ability to grasp and deal constructively with the complex issues which have already come before it.

It is perhaps significant that the American Stock Exchange has undertaken a similar major effort to reorganize its governing structure. Earlier this year, in an appearance before the House Subcommittee on Commerce and Finance, the President of the NYSE and I commented at some length on the approach to a central exchange system. We stated at that time:

"As an essential part of this approach...the other stock exchanges and the NASD should be reorganized along the same lines as the reorganization of the New York Stock Exchange, to broaden public representation on their governing boards."*

I should add that the NYSE recognizes --as the House Subcommittee on Commerce and Finance has also noted-- that Public Directors may often be less familiar than Industry Directors with the background and details of many problems with which they will have to deal. If Public Directors are to make a meaningful contribution, they must be in a position to

*Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives; 1972; Part VII: p. 3802.

reach completely independent judgments based on a knowledge of all the facts concerning policy matters. To facilitate this, the Exchange has created a new full-time post of Counsel to the Board of Directors, with responsibility for helping them to obtain material necessary to an objective evaluation of the policy questions which come before the Board. The cost of providing this facility --including whatever supporting staff Counsel to the Board may require-- is being borne by the Exchange.

* * * * *

The final question on which we have been invited to comment deals with Improving the Methods of Adopting Rules and Disciplinary Procedures. The thrust of this question would seem to be in the direction of greater public participation in and awareness of the rule-making processes of self-regulatory organizations. We support that objective.

I think this is abundantly clear from the nature of the NYSE's reorganization of its governing body, whereby we have provided for much greater public participation in the deliberative and rule-making process than has ever before existed in the securities industry.

We have also instituted significant changes in NYSE disciplinary procedures in recent months, proceeding from the firm belief that judgment by one's peers tends to produce the most just decisions.

Under our new procedures, the composition of Hearing Panels will

assure that an accused person is judged primarily by his or her peers -- that is, by members, allied members, registered persons and other employees, as the case may warrant. All accused persons have the right to legal or other counsel. And the right of appeal to the Board of Directors is guaranteed to all parties to a disciplinary action; in addition, any action is subject to Board review on the initiative of any Director.

In the past, the Exchange has been criticized, justly or not, for the timing of public announcements of disciplinary actions. We are now issuing such announcements in mid-week to facilitate their use by the daily press.

With respect to publicizing proposed Exchange rules, it may be noted that the President of the NYSE told the House Subcommittee on Commerce and Finance, on November 17, 1971, that the Exchange would support the concept that all proposed rules of national securities exchanges should be publicized by the SEC: that important rules should be the subject of SEC public hearings or that the Commission should solicit comments on proposed exchange rules as had been suggested in a note in the Yale Law Journal.

We note that the House Subcommittee's Study Report states the Subcommittee's intent to introduce legislation which would "require the Commission to release proposed rules and rule changes of registered national securities exchanges and registered national securities asso-

ciations to the public well in advance of their proposed adoption date."**

I think it is pertinent to note also that NYSE Chairman James J. Needham has inaugurated the practice of personally briefing representatives of the news media on actions taken by the Exchange's Board of Directors. These press briefings occur immediately after the conclusion of Board meetings and supplement the Exchange's practice of immediately releasing printed accounts of such actions to the media.

While the new Board has not yet reviewed all aspects of the question of greater public participation in and awareness of Exchange rule-making procedures, I expect that they will do so in the relatively near future.

* * * * *

As I noted earlier, the series of hearings held by this Subcommittee and other Committees of Congress during 1971 and 1972 have provided valuable insights into areas of securities industry operations and regulation where constructive changes may be needed. I believe the experience has been useful for all of the participants.

We would hope that whatever legislation may result from these hearings will enable the government regulatory authorities to continue

** See "Securities Industry Study", Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives; 1972; Page 110.

their cooperative working relationships with the stock exchanges and the NASD.

I think we all want to work together to improve and strengthen the existing regulatory relationships in the public interest. By so doing, we can establish and give meaning to a system of cooperative regulation which must inevitably strengthen the securities industry and give a new dimension to the commitment which we share with the SEC and the Congress to promote and protect the public interest.

EXHIBIT A

Reorganized NYSE Board Picks Its New Chairman



In a series of history-making events over the last two months, the membership of the New York Stock Exchange elected 20 members to a reorganized board of directors and the new board elected the Exchange's first fulltime, salaried chairman and chief executive.

The new chairman is James J. Needham, 45 years old, who has been a member of the Securities and Exchange Commission. He is the first person outside the Exchange community to hold the post. Previously, the chairman was elected by the NYSE membership, was a member or allied member and served part-time without pay.

In announcing the Needham appointment, Ralph D. DeNunzio, who has been chairman for the last year, said: "The members of this new publicly oriented board sought as chairman a man of great integrity with a broad knowledge of the securities industry and a strong regulatory background. The board decided to reach outside the securities industry for a man with all these qualifications. We feel certain that Mr. Needham amply meets these requirements and that he will be a vigorous and distinguished chairman of the board."

Mr. Needham has been an SEC commissioner since 1969. Previously,

he had been a partner in charge of the New York office and a member of the executive committee of A. M. Pullen & Co., an accounting firm. He is a Certified Public Accountant. The St. John's University graduate is a native of New York City, is married and has three sons and two daughters.

Martin report a factor

The reorganization of the board stems from a report submitted to the Exchange last December by a special committee headed by Cornelius W. Owens, a public member of the previous board and continuing as a public member of the new board. The report was based on an earlier one by William McChesney Martin Jr., in August 1971, which was made at the Exchange's request. The new board consists of 10 members from the public and 10 from the securities industry. The previous board had 33 members, including three from the public.

Among the public members chosen are two firsts: Jerome H. Holland, the first black member, and Juanita M. Kreps, the first woman to serve on the board. Dr. Holland, who served for 10 years as president of Hampton Institute in Virginia, has been U. S. Ambassador to Sweden since 1970. He is a graduate of Cornell University, where he was twice named to All-American football teams, and holds a Ph.D. from the University of Pennsylvania.

Dr. Kreps is a professor of economics, dean of the Women's Col-

lege and Assistant Provost at Duke University. She has written extensively on labor and manpower and the economics of aging. She earned her master's and doctorate degrees from Duke after graduating from Berea College.

Following are details of the backgrounds of the public members:

William M. Batten has spent his entire business life with J. C. Penney Co. Inc. He joined the department store chain as an extra salesman in 1926, became a regular salesman in 1928, then moved up through executive ranks. He was named president in 1958 and elected chairman in 1964. He also is chief executive. Mr. Batten, 63, is a 1932 graduate of Ohio State University with a B. S. degree in economics and did graduate work at the University of Chicago.

Karl R. Bendetsen has been chairman of Champion International (formerly U. S. Plywood-Champion Papers Inc.) since 1967 and chief executive since 1968. Prior to the merger of U. S. Plywood and Champion Papers in 1967, Mr. Bendetsen served as chairman, president and chief executive of Champion. Mr. Bendetsen, 64, holds bachelor's and law degrees from Stanford University. In the years after World War II, he held a number of government posts, including Assistant Secretary and Undersecretary of the Army.

Donald C. Cook is chairman, president and chief executive of American Electric Power Co. Inc. He was named president and chief executive in 1961 and chairman in 1971. Mr. Cook holds a bachelor's

degree and a master's degree in business administration from the University of Michigan and the degrees of juris doctor and master of laws from George Washington University. He is also a Certified Public Accountant. Mr. Cook, 63, was chairman of the Securities and Exchange Commission in 1952 and 1953; vice chairman, 1950-52, and commissioner 1949-50. He was also chief counsel to the Preparedness Investigating Subcommittee of the Senate Armed Services Committee, 1950-52, and director of the Office of Alien Property of the Justice Department, 1945-47.

William C. Greenough, 57, has been chairman and chief executive of the Teachers Insurance and Annuity Association of America and the College Retirement Equities Fund since 1967. The two organizations provide retirement and investment programs for professional educators. Dr. Greenough joined TIAA in 1941 and was named a vice president in 1948. He became vice president of CREF in 1952. He was named president of the two funds in 1957. He holds a doctor of laws degree from Indiana University and a Ph.D. from Harvard University.

Jerome H. Holland. His career has embraced the fields of teaching, industrial personnel administration, research, educational administration and writing. His latest publication is his recent book entitled "Black Opportunity." He is 56 years old.

Juanita M. Kreps is the author or editor of seven books, three monographs and more than 50 articles.

She has held teaching posts at Denison University, Hofstra College, Queens College, the University of North Carolina and North Carolina State University. She is married to Dr. Clifton H. Kreps Jr., Wachovia Professor of Banking at the University of North Carolina. They have three children.

Raymon H. Mulford is chairman and chief executive of Owens-Illinois Inc., manufacturer of glass and paper containers with headquarters in Toledo, Ohio. He has held the post since 1968. Mr. Mulford joined Owens-Illinois in 1933 and served in a variety of assignments. He was named president, chief operating officer and a director of the corporation in 1961. He became chief executive four years later. Mr. Mulford, 62, was graduated from Stanford University with a bachelor's degree in economics in 1931. Two years later he was awarded an MBA degree from the Harvard Graduate School of Business.

Cornelius W. Owens is executive vice president of American Telephone and Telegraph Co. and has been a public representative on the New York Stock Exchange's Board of Governors since 1968. Up to 1970, he had been president of New York Telephone Co. He began his Bell System career in 1937 with New England Telephone and Telegraph Co. in Boston, holding supervisory jobs in the personnel and plant departments. Mr. Owens, 58, is a native of Boston and a graduate of Boston College.

James M. Roche, 65, retired as

chairman and chief executive of General Motors Corp. on December 31, 1971. He remains a member of the board and the finance committee. He was elected a member of the GM board in 1962 and served as president of the corporation from 1965 until he was elected chairman in 1967. Mr. Roche joined GM's Cadillac motor car division Chicago sales and service branch in 1927. Within a year he was named assistant to the Chicago branch manager. Rising through several posts, Mr. Roche achieved the top position in the Cadillac organization in 1957, being named general manager and a GM vice president.

Robert W. Sarnoff, chairman of RCA, has had a career of more than 30 years in the information and communications industries. He became president and chief operating officer of RCA in 1966. He was named chief executive in 1968, was elected chairman two years later and last year relinquished the title of president. Before moving to the parent company, Mr. Sarnoff spent a decade as chief executive of National Broadcasting Co., first as president and then as chairman. He worked for the publisher of the Des Moines Register and Tribune and for Look magazine before joining NBC. Mr. Sarnoff, 53, holds a B. A. degree in government and philosophy from Harvard University.

The following are the new board's 10 industry representatives:

Warren H. Berl, chairman and president, Sutro & Co., an NYSE member firm headquartered in San Francisco.

James W. Davant, chairman and chief executive, Paine, Webber, Jackson & Curtis.

William H. Donaldson, a founder, chairman and chief executive of Donaldson, Lufkin & Jenrette Inc., the first NYSE member firm to become publicly owned.

John J. Flanagan, general partner in Josephthal & Co., who served as a member of the Board of Governors from 1965 to 1971.

Walter N. Frank, senior partner in the NYSE specialist firm of Walter N. Frank & Co., who served as chairman of the Exchange's Board of Governors from 1965 to 1967.

Bernard J. Lasker, senior partner of Lasker, Stone & Stern, an NYSE member firm. He served as chairman of the Board of Governors from 1969 to 1971.

Gustave L. Levy, senior partner in the NYSE member firm of Goldman, Sachs & Co., who served as chairman of the Board of Governors from 1967 to 1969.

Harry C. Piper Jr., chairman of the NYSE firm Piper, Jaffray & Hopwood Inc., Minneapolis, Minn., served as a member of the Exchange's Board of Governors from 1963 to 1966 and was re-elected in 1969 to a three-year term.

Donald T. Regan, chairman and chief executive of Merrill Lynch, Pierce, Fenner & Smith Inc.

Ralph S. Saul, chairman of the executive committee of First Boston Corp., who has been an Exchange governor since October 1971. He was president of the American Stock Exchange from 1966 until June 1971. ●

TESTIMONY OF THE
PACIFIC COAST STOCK EXCHANGE

Thomas P. Phelan
President

INTRODUCTION

On behalf of the Pacific Coast Stock Exchange I am pleased to have this opportunity to testify before your subcommittee. Because of the relatively short notice concerning this hearing, I was not able to ascertain the views of the Board of the Pacific Coast Stock Exchange concerning the issues under consideration here. My statements today, therefore, should not be understood as necessarily stating the views of the Board of the Pacific Coast Stock Exchange.

My association with a self-regulatory agency in the securities industry dates back more than forty years to the era before the Exchange Act when self-regulation was the only form of regulation. I have had an opportunity to witness the development of self-regulation and the development of the role of the Securities and Exchange Commission as regulator of the self-regulators. In general, the self-regulatory scheme of the Exchange Act has worked quite well. The United States has a capital market second to none in the world. Public confidence in this market, and public participation, is much greater than in any other major country.

Some recent events have, however, suggested deficiencies in this regulatory scheme. Important developments such as development of a central market system and development of a national system of

securities depositories have been hampered by rivalries between self-regulatory agencies. In some areas of their operations, self-regulatory agencies are uncertain of their ability to regulate because of threats of antitrust liability. The self-regulatory agencies have played a vitally important role in the American system of securities regulation. If they are to continue playing this role in the future, however, the two problems mentioned above must be resolved. Methods will have to be developed to improve cooperation between self-regulatory agencies, and the antitrust responsibilities and exposure of self-regulatory agencies will have to be better defined.

Having made these general comments, I would now like to comment specifically on the questions proposed by the Subcommittee.

The Question of Reallocating Authority Among the Self-Regulatory Agencies.

Currently, there are wide areas of overlap between the regulatory authority exercised by the various self-regulatory bodies. In practice, however, the self-regulatory bodies have achieved a large measure of agreement about who regulates whom and who regulates what. Jurisdictional disputes still arise, but they generally are resolved without serious inefficiency and without any loss in regulatory effectiveness.

I do not see a need for new legislation defining the jurisdiction of the self-regulatory bodies. Legislation would freeze patterns of regulatory responsibility. The present system has the advantage of flexibility in that it allows a self-regulatory body, such as the Pacific Coast Stock Exchange,

to leave primary regulatory responsibility over a member to a larger exchange to which such firm belongs, while retaining the power to assume jurisdiction if this is necessary. An exchange, or other self-regulatory body, has a responsibility to protect itself, its clearing corporation, and its members, from losses occasioned by the economic instability, or improper conduct, of a member. Unless a self-regulatory body has jurisdiction over the conduct of all of its members, it can not fulfill this responsibility.

The Composition of the Governing Boards of Self-Regulatory Agencies.

The governing boards of self-regulatory agencies should be, first of all, representative of the agency's membership. The board should not be dominated by any particular set of interests, such as the floor. It is for this reason that the Pacific Coast Stock Exchange has the rule that two of the three governors elected each year must be "office members or office allied members of the Exchange."

The extent to which the governing boards of self-regulatory agencies should be representative of the public raises a much more difficult question. And the answer to this question may differ if we are talking about the board of a primary market, such as the New York Stock Exchange, or if we are talking about the board of a regionally-oriented exchange, such as the Pacific Coast Stock Exchange. Since the New York Stock Exchange has greater public impact than the Pacific Coast Stock Exchange, the arguments for public representation on the board of the New York Stock Exchange may be greater.

On a broader plane, I have lingering doubts about the benefits of

public representation, at least as it has been conceived to date. It seems to me that the public is not really being represented on a board unless it has chosen its representatives. There is no necessary reason why the chairman of a large listed company is any more representative of the public, or of the investing public, than an officer of a member firm which does a large retail securities business. The opposite may well be true. An officer of a member firm doing a retail business has substantial contact with the investing public and substantial reasons to be sensitive to the needs of the investing public. An officer of a member firm also will be knowledgeable about industry problems. Board members from outside the securities industry would have to devote substantial time and effort to educating themselves in order to contribute meaningfully to board decisions. Public representation may thus be merely cosmetic, without any real effect on the responsiveness of such boards to the public.

Historically in this country we have expected members of the governing boards of the self-regulatory agencies to be men who are able to take a broad view of industry problems and who are sensitive to protecting the public interest. We have not, however, expected them to be representative of the public. To represent the public, and to ultimately protect its interests, we have relied upon continuing inputs from Congress, which is representative in a real sense, and upon continuing supervision from the Securities and Exchange Commission, which is required to be responsive to the public interest because it is responsible to Congress. All the recent discussion about public memberships on the boards of the self-regulatory agencies has not yet convinced me that there is anything to be

gained by departing from this historical pattern.

Procedures Followed by Self-Regulatory Agencies in
Adopting Rules and Policies.

Today as we are moving toward a central market system, and toward a national system of securities depositories, actions taken by one self-regulatory agency increasingly have substantial effects on other self-regulatory agencies. For this reason, I propose that whenever a self-regulatory agency files a rule or policy change with the Securities and Exchange Commission, it should be required contemporaneously to mail the proposed change to all other self-regulatory bodies. Rules which are concerned solely with internal management might be exempted from this requirement. Such a provision, which should be added to H. R. 15303, would give other self-regulatory agencies a chance to comment on the proposed changes before the Commission allows them to become effective.

The Proposals Contained in H. R. 15303.

The Securities and Exchange Commission has the responsibility for protecting the health of the nation's securities markets. It has to have adequate statutory authority to fulfill this responsibility. H. R. 15303, proposed by the Commission, would give the Commission additional power which it believes is needed. With respect to exchanges, the Commission would gain the power to take disciplinary action against a member or person associated with a member if such person violates an exchange rule.

The Commission would also be given the power to review the disciplinary proceedings of exchanges. Finally, the Commission's powers under Section 19 (b) of the Exchange Act would be expanded and its procedural freedom increased. I see nothing to oppose in the first two proposals. Discipline often involves questions affecting the public interest, and it is appropriate that the Commission receive greater power to intervene in this area.

I find the third proposal, involving an amendment to Section 19 (b), generally acceptable, but I have reservations about the procedural effects of this amendment. I do not object to the idea that the Commission should no longer be limited, in its substantive power, to the items enumerated in Section 19 (b), plus "similar matters." I do see some problems with exempting the Commission from formal rule-making without specifying a satisfactory procedural substitute.

Under Section 19 (b) as it now stands, there are substantial doubts about the Commission's power to act except by formal proceedings in which evidence is submitted orally, testimony is subject to cross-examination, and the decision must be based upon a record. I believe that this procedure is too cumbersome to allow the Commission to meet its broad responsibilities. The language proposed in H. R. 15303, however, would go too far in the opposite direction. For example, the Commission is proposing that it be exempted from the requirement that when a hearing is held, the rule cannot be finally adopted until the hearing is completed. An opportunity for hearing, afforded after a rule has been adopted, is an illusory right. This provision should be modified so that only in cases of emergency could

the Commission adopt a rule before completion of a hearing. In such cases, the Commission should be required to state the nature of the emergency, and the reason that it is essential for action to be taken prior to a hearing.

I believe it is possible to devise a middle course which does not hamstring the Commission as formal rulemaking does, but which gives interested parties sufficient procedural rights to insure that their views are considered by the Commission. Therefore, I suggest that the following changes be made in the Commission's proposed amendment to Section 19 (b):

- (a) The Commission's proposal merely requires that notice be given in the Federal Register. H. R. 15303 should be amended to provide that, in addition to publication in the Federal Register, notice must be sent by mail to all national securities exchanges and registered securities associations.
- (b) The Commission's proposal requires only a minimal form of notice, stating either the substance of the proposed rule or describing the issues involved in it. H. R. 15303 should be amended to provide that the Commission's notice must contain a preliminary statement of the reasons for the proposed rule. Such a statement will give interested parties something on which to focus in making a response.
- (c) The Commission's proposal does not grant a right to make an oral presentation to the Commission. I agree that there is no reason to require that oral evidence be heard by the Commission. However, any

national exchange should have the right to submit evidence in writing and to appear before the full Commission for oral argument in connection with any rule under Section 19 (b) which would affect such exchange directly or indirectly.

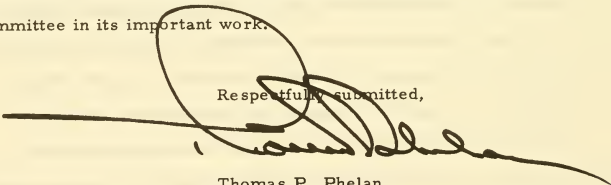
- (d) The Commission's proposal does not require that decisions be made upon the record. It is not unduly onerous to require the Commission to tie their decision to the record that has been created. Only if this is done can there be any meaningful right to judicial review.

With these modifications, I believe that the Commission's proposed amendment to Section 19 (b) can represent a substantial improvement over the present statute.

Conclusion.

I have enjoyed this opportunity to appear before you on behalf of the Pacific Coast Stock Exchange. I hope that my remarks will assist the Subcommittee in its important work.

Respectfully submitted,



Thomas P. Phelan
President
Pacific Coast Stock Exchange

MEMORANDUM

Submitted By

PBW STOCK EXCHANGE, INC.

We appreciate the opportunity to appear at this Hearing that the Subcommittee has scheduled for October 5, 1972, and to contribute our thoughts on the important questions raised in Chairman Williams' letter of September 21, 1972. We have organized this Memorandum to answer the various questions set forth in your letter

I. Possible reallocating authority among the various self-regulatory agencies.

The PBW Stock Exchange, Inc. (PBW) strongly favors the self-regulatory process as promulgated under federal securities laws. Within this context, the PBW feels that a cooperative relationship should exist between the various regulatory agencies while for the future we favor autonomy within the system.

This cooperation between regulatory agencies presently manifests itself in the cooperative enforcement program already in effect. The program itself, while very effective, also fosters a sound basis for understanding and appreciation of the many problems and difficulties which arise in the regulatory process as they relate to the respective regulatory areas of the participants. The PBW, therefore, feels that greater emphasis should be placed on this program with a view

toward expanding the scope of the program now in effect.

Greater emphasis and expansion of the cooperative enforcement program should encourage the various regulatory agencies to strive for specific areas of agreement as to the activities over which each agency should exercise authority. We feel the areas for potential agreement should include but not be limited to: a) broker-dealer inspections; b) broker-dealer reporting; c) sales practices; d) record keeping requirements and uniform interpretive policies.

Within this framework the Securities and Exchange Commission (Commission) would continue to have oversight responsibilities for the activities of the various self-regulatory agencies.

II. Composition and Manner of Selection of Governing Boards.

We believe at the present time each of the self-regulatory organizations should be able to determine the applicable rules applying to the composition and manner of selecting members of their boards. Present supervision by the Commission and judicial review is adequate to ensure due process.

It is quite possible the boards of self-regulatory bodies will need to be changed in response to the changes in the structure of the Nation's securities markets. Market structure changes will probably require representation by public investors and companies whose securities are traded on the boards. However, because of the complexity of problems to be considered, we believe that governing boards should be composed primarily of industry members.

The governance of separate market-making centers should be a full time responsibility for at least some of the key personnel responsible for day-to-day operations. Accordingly, the market-making centers or self-regulatory agencies should have adequate professional staffs which enjoy a degree of autonomy.

The PBW does not believe that any Congressional or Commission action is required at the present time to alter the structure of the boards of existing self-regulatory organizations. We do not believe government action is necessary because competitive forces should create economic pressures to make the boards of the separate markets more responsive to the needs of the investing public.

III. Procedures of Self-Regulatory Agencies in Adopting Rules and Policies and Conducting Disciplinary Proceedings.

The Exchange Act now charges such agencies as being affected with a public interest, vests them with quasi-governmental power, and subjects them to oversight by the S. E. C. which may grant or withhold an exchange's registration in accordance with statutory standards of conduct, referring *inter alia*, to enforcement capability, performance, and fair administration of exchanges. S. E. C. Rule 17a-8 requires advance notice to the Commission of proposed rule changes by exchanges. The present law appears to us to be adequate in terms of residual Federal power, standards and sanctions.

Improvement in procedures should be concerned with professionalism, objectivity, staff capability, due process and possible conflicts with other areas of the law such as anti-trust.

A professional approach by board and committee members and by staff should be encouraged and required. In the long run self-interest and the public interest interact to serve each other. If they cannot do so, present legislative sanctions can be invoked in favor of the public. Rule-making should allow for adequate notice to a membership with varied spectrums of interest. Using such procedure initially, the other guidelines, objectivity and procedural due process, can be

more readily achieved. Present reporting requirements under the Exchange Act provide adequate notice to the S. E. C.

The procedure in and conduct of disciplinary proceedings similarly require due process, objectivity and professionalism. Appellate remedies are available in Federal and state courts. An aggrieved party can now complain to the S. E. C. for failure of an exchange to follow its rules or fairly administer its affairs.

Attainment of all of the foregoing objectives can be facilitated by the upgrading of the competence and responsibilities of professional staff personnel. Formal delegation of authority by governing boards becomes part of the rules and policies of an exchange for which there is legal responsibility for enforcement.

Conflicts between the statutory scheme of self-regulation and the anti-trust laws are both real and potential. Self-regulatory procedures conceptually imply certain types of concerted action which should be protected.

There is considerable uncertainty regarding the extent of implied anti-trust immunity, which has evolved to date through judicial opinions, for actions complying with self-regulatory requirements. We believe that Congress should act to balance competing interest - the need for self-regulatory authority within appropriate limits, and the need for reasonably certain guidelines to insulate concerted actions

against anti-trust liability to the extent that the public interest requires.

Extremely complex issues are inherent in determining the precise extent to which anti-trust immunity should be granted. We are not prepared at this time to propose specific legislation for this purpose.

Present self-regulatory procedures have worked. They can, of course, work better. Their foundation and structure are worth preserving and encouraging. Direct governmental participation should be held to a minimum to encourage decentralization, flexibility and initiative. Indicated improvement should first be sought through more vigorous enforcement and use of the present statutory scheme and common law guidelines.

IV. Appropriate Legal and Operational Relationships Between Regulatory Agencies and the S. E. C.

The appropriate legal relationship between the self-regulatory authorities in economic areas should be one of competition, rather than regulation. The PBW has attempted to provide competition between marketplaces by providing membership to all registered broker-dealers who meet capital and competency requirements; providing competition between specialists and third market-makers on our floor; and displaying the quotations of our market-makers in the NASDAQ and AuTex systems.

We support the concept of a central market system. However, we envision the central market consisting of legal separation of market-making centers each being autonomously regulated. All markets should be linked electronically and thus brought into competition, and all trades reported on a composite tape.

We believe there are no legal or possible operational relationships which required each center to have uniform, or what has been termed "equal regulation". Uniform rules are unnecessary provided that certain minimum requirements are imposed throughout the industry to ensure an appropriate level of professional competence.

No market center should be relieved of the pressure of competition from other marketplaces, especially in the near term future when the

entire market structure can be expected to evolve rapidly in response to both legal and technological developments. So long as each marketplace meets or exceeds minimum standards, the freedom of each to tailor its own rules should not be restricted by a need to conform to the rules of any other marketplace.

If a particular practice is considered to be unfair competition, that practice should be dealt with directly. However, whatever justification there may be to eliminate particular unfair competitive practices, there is no justification whatsoever for eliminating all diversity by imposing a uniform set of rules on all competitors.

We believe, as discussed in Section I of this memorandum that the operational relationships in the area of competitive regulation and supervision of members should be expanded.

Clearance and the processing of securities are key areas for the development of operational relationships between regulatory agencies. This Subcommittee has considered much testimony in this area and has recommended certain legislative solutions. We have submitted our views and recommendations, and it is not necessary to reiterate them in detail. We generally support steps which will create operational efficiency between members and other regulatory agencies.

This Exchange does not favor the adoption of H. R. 15303. House Bill H. R. 15303, in part, amends Section 19(b) and confers upon the Commission new authority with regard to the adoption, amendment, alteration or rescission of rules of self-regulatory organizations. The proposed Section 19(b) provides the Commission with the broadest of powers in the rule making area with limited recourse by an Exchange to question the action by the Commission. One must immediately question the necessity of dramatically increasing the powers of the Commission. Such an increase in power would severely limit the concept of self or cooperative regulation.

This Bill would eliminate the valuable contributions made by existing exchanges in the area of regulation and innovation. When Congress was considering the adoption of the Securities Exchange Act of 1934 it realized that the concept of self-regulation would be a foundation of the Act.

H. R. 15303 conveys upon the Commission direct power and control over areas which Congress in the first instance delegated to the self-regulatory bodies. This Bill would strain the regulatory and administrative responsibilities of the Commission and there is great danger of the whole regulatory structure breaking down under its own weight and proving ineffective.

Increased direct Government regulation would have the following adverse effects:

1. Pronounced expansion of the organization of the Securities and Exchange Commission in terms of staff and multiplication of branch offices.
2. Large increase in expenditure of public funds.
3. And the danger of imposing rigid regulation on a business which would limit competition and stifle growth.

It should not be forgotten that although initial responsibility in many areas is left with the exchanges, the Commission is vested today with powerful oversight powers if the exchanges do not meet their charged responsibilities.

In addition, H. R. 15303 amends Section 19(a) of the Securities Exchange Act by adding a provision providing commission review of disciplinary actions by self-regulatory organizations against their members.

These amendments, as do the amendments to 19(b), increase direct governmental regulation with the inherent adverse effects of expansion of the Commission organization; increased expenditure of public funds; and restrict competition by improving rigid regulation.

The PBW certainly does not oppose Commission review of disciplinary action taken by the Exchange against a member, or person associated with a member. However, the Exchange is troubled that the amendments to Section 19(a) may be interpreted as creating an affirmative duty by the Commission to review all disciplinary actions by the Exchange. Such an interpretation would create overwhelming administrative problems for the Commission.

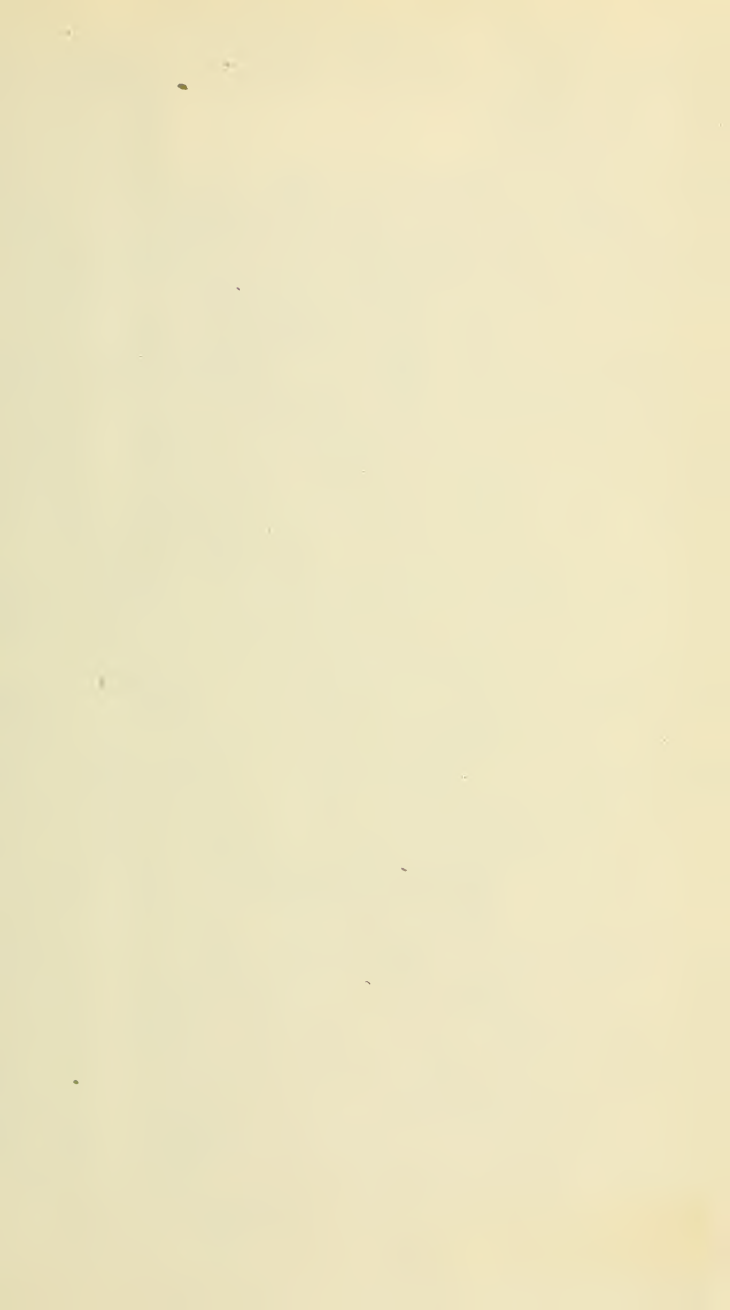
Finally, the PBW believes that due process and fair dealing is provided in disciplinary actions by the Securities Exchange Act of 1934, the PBW Constitution and Rules, and by judicial review.



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