MEMORANDUM

To: COMMITTEE ON INTERNAL REORGANIZATION

From: Frank J. Wilson

Date: March 25, 1968

Re: Background Re: Review of Section 25

In view of the fact that the question of reviewing the provisions of Section 25 of Article III of the Association's Rules of Fair Practice concerning dealing with non-members has been referred to you, which review is necessitated by the entry of insurance companies into the mutual fund and variable annuity fields, I thought it would be advisable if I reviewed briefly some of the background, stated the problem and posed some of the alternatives available to the Committee.[1]

Initially, you will undoubtedly recall that the Internal Reorganization Committee completely reviewed Section 25 about a year and a half ago and that the Interpretation concerning "Transactions Between Members And Non-Members" was redrafted and, after Board approval, submitted to the Commission for its approval. The Commission raised certain objections as a result of which the Committee subsequently recommended to the Board that the Interpretation be allowed to remain as it then existed and that no changes be made. Administratively, it would continue to be enforced as in the past. A copy of the Commission's memo of objections and a memo from me relating to a subsequent meeting with the staff in respect to the objections can be found at Tab 4 and are self-explanatory of the Commission's view.

The question of the effect of Section 25 on the variable annuity people was not before the Committee at that time since the problem arose only in the past six months to a year. During this period approximately 20 to 25 insurance company subsidiaries have become members of the Association. A list of those companies and their subsidiaries can be found at Tab 2. For the most part, these companies sell only mutual funds but there are three which also sell a variable annuity product. It is the latter with which we are primarily concerned but the review of Section 25 will have to be a little broader than that single subject.

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[1] Additional background can also be found in a memorandum written by Paul Welch, already forwarded to you, and which is included herein at Tab 3. As Bruce Simpson told you when he forwarded this memo, the situation has changed somewhat since it was written.

From the time the insurance companies became interested in the equity field, especially in the area of variable annuities, questions have continually arisen in respect to the effect of our rules upon them. It was recognized that their situation was somewhat unique since, notwithstanding judicial determinations by the Supreme Court that a variable annuity is a "security" under the 1933 Act, it is essentially an insurance product and in most states falls under the jurisdiction of the insurance commissioner.

In addition to the Section 25 considerations in respect to insurance companies, questions have also arisen relative to taking of examinations by the large number of representatives employed by them and who presumably would be registered through the broker/dealer subsidiary when it became a member of the Association, and the application of certain other of the Association rules to their operation. The questions concerning examinations have apparently been substantially worked out. In one case, registration of all of the salesmen was permitted conditioned upon their passing the examination within a stated period of time. During the interim they would be permitted to sell their company's product. This action evolved as a result of the attitude of the Board expressed at its meeting in September, 1967 that these new companies could be accommodated within the framework of the NASD and that the Board would do all it could to recognize and attempt to meet specific problems. A subsequent mail vote of the Board, specifically authorized the examination grace period. At the September Board meeting the creation of a Variable Annuity Committee was also authorized with a view toward working out the various problems relating to the variable annuity group. This Committee now has as one of its members, a representative of one of the insurance company subsidiary members of the Association. These moves by the Association have apparently led the group to believe as was the intent behind them, that the Association is in fact trying to recognize and solve problems indigenous to them. They were previously of a different mind or skeptical at best.

The Variable Annuity Committee at a meeting on October 27, 1967, concluded after reviewing all of the problems that the Section 25 issue was the only one which did not seem to have a fairly easy and readily attainable solution. A copy of that report and its report to the Board in January, 1968, are included herein at Tab 1. In its report to the Board in January, the Committee acknowledged its awareness that the problems in respect to Section 25 were part of a much larger issue and that an examination of Section 25 should not be made from a variable annuity point of view strictly but, rather, in the context of the entire structure of the NASD. For that reason, it recommended to the Board that a committee be created to examine and review Section 25. The Board adopted the recommendation but rather than creating a new committee, the Chairman of the Board was of the opinion that the Internal Reorganization Committee would be the appropriate committee to review the matter, especially since it had done so in the recent past.

Essentially, the problem is whether the Association should relay its insistence that members should not join with non-members in the distribution of securities -- at least in the insurance company-mutual fund and/or variable annuity field. This problem arises, in part at least, because of the desire of some insurance company subsidiary members to market their mutual fund product through an NASD underwriter and their variable annuity product through a SECO underwriter, either of which may or may not be a subsidiary.

Another twist is the situation where the general agency concept is used by an insurance company as its distribution method. This distribution method, of course, results from previous methods of selling insurance. Some such general agencies are already registered with SECO for the purpose of selling VALIC, Variable Annuity Life Insurance Company, which has been in business many years. In any event, the insurance company has no control over what the agency sells, different types of insurance, on the one hand, or mutual funds and/or variable annuities on the other, but if it sells a SECO underwritten variable annuity, for instance, we must tell our members, in this case the insurance company subsidiary member, that it cannot market its variable annuity or mutual fund through that general agency since such, under Section 25, would constitute joining with a non-member in a distribution of securities.

There are other variations but the problem, generally, can be summarized by reference to the following situations:

(a) a situation where a corporate parent has, or desires to establish, two subsidiary broker/dealers, one a member of the Association and one a member of SECO, the purpose being, apparently, to sell its mutual fund through NASD members and its variable annuity through SECO members, or a situation where the parent desires to sell its product or products through both SECO and NASD members, whether subsidiaries or not;

(b) a situation where a registered representative desires to be registered with an NASD member and a SECO member. This problem arises generally in situations where a registered representative-insurance man is now registered, for example, with a SECO general agency selling VALIC, and now desires to be registered with an NASD member to distribute additional products or the product of a given company;

(c) the general agency situation described above.

Administratively, we have taken the position that dual registration, dual membership and dual subsidiaries cannot be permitted where the duality involves both an NASD and a SECO member. Unfortunately, however, we are aware of at least three cases where there is dual membership. This arose because of an unawareness of the corporate structure at the time.

Another offshoot of the problem is a situation where sales are made by a registered representative, registered perhaps with a broker/dealer subsidiary of an insurance company but actually working out of a general agency which is not a registered broker/dealer or in the securities business in any way. Certain companies have expressed a desire to have the commissions flow to the registered representative through the general agency the same route their insurance commissions follow. They explain that it would be merely a conduit for the funds. It would be difficult, however, for the Association, in view of the fact that it would not have access to its books and records, to determine whether the agency was receiving a portion of the commissions for the securities sales or, to state it differently, whether the registered representative was sharing commissions with someone not in the securities business.

There has been an indication that the variable annuities people may very well attempt to set up an affiliate association composed of members of its own group. This would, of

course, have to be approved by the Commission. If this happened, our immediate problem would perhaps be eliminated. This is only in the formative stages but it looks like they are serious about doing so. If it is done, the affiliate association would have to adopt rules similar to ours and meet the requirements of the Maloney Act concerning affiliated associations. The group proposing this approach, representatives of the American Life Convention, has even suggested that it might adopt the NASD's rules en toto with one or two adjustments to meet their own situation. An undertaking such as this would undoubtedly be much more expensive to them than by going with the Association or SECO so it may very well never come to pass.

In sum, the problem in connection with the variable annuities group, specifically, and the insurance mutual fund group, generally, is only as large as the Association wants it to be. In other words, a decision must initially be made whether Section 25 should be changed to accommodate them. If that decision is in the affirmative, the extent to which changes should be made must then be determined.

Apparently the changes which these people would like to see would be permission for a registered representative to be dually registered with an NASD member and a SECO member as long as his SECO activities are restricted to selling shares registered pursuant to the 1940 Act -- at least that is one approach -- and to permit any broker/dealer, whether an NASD or SECO member, to participate in any open-end distribution. Our members could thereby receive dealer concessions if the salesman sold a product underwritten by a SECO member and the SECO member could receive concessions if a salesman sold a product underwritten by an NASD member. An accommodation to permit a general agency non-broker/dealer to be the conduit for commissions to registered representatives is also desired.

Other considerations are important, however, in resolving the current Section 25 problem and, though probably not all-inclusive, some of them are as follows:

1. Can we prevent a SECO member from owning an NASD member?[2]

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[2] This situation is demonstrated by a recent attempt on the part of Hamilton Management Corporation (HMC), a SECO member, to have Hamilton Securities Corporation (HSC), a wholly-owned subsidiary, become a member of the Association. This situation does not involve insurance companies but it very well could. In any event, the situation, described hereinafter, gives rise to a new question involving Section 25 which must be considered by the Committee.

In the Hamilton situation, HMC is the principal underwriter of Hamilton Funds, Inc. and it was stated in connection with the HSC application that HSC would receive give-ups on portfolio transactions of the fund, and that contractual arrangements between the fund and HMC would adjust the advisory fee to HMC by the total amount of giveups. In sum, money would be flowing through a member back to a non-member because of the ownership status. The Board rejected the application for registration reasoning that the total picture, not just the application of HSC, must be viewed. With this in mind, it concluded that the effect of HSC's registration with the Association would constitute registration with both entities. The SEC questions this approach by us and asked for the

2. Can we stop commissions from going through non-broker/dealer general agencies as noted above? If we can, should we?

3. Should we establish a separate class of registered representatives who would sell only variable annuities, and perhaps a separate class for mutual fund salesmen as well? If so, should such be limited to insurance company situations?

4. Should we have a limited class of membership?

5. Should we go on record in favor of an affiliated association for variable annuity people?

6. Where do our supervision requirements fit into the whole picture?

There are two sides to the question of whether Section 25 should be changed, however. On the one hand, there is a feeling that it should be changed to accommodate the variable annuity people and that if the Association does not do so the possibility exists that all of these companies representing thousands upon thousands of potential registered representatives or a good percentage of them, would drift toward SECO. I personally am not sure the situation is that clear-cut especially since the drift at the present time, contrary to what it was several months ago, seems to be toward the Association. Thus, another alternative to changing Section 25 would be an attempt to sell the Association for what it is rather than to undertake changes which, with the passage of time, may prove unwise. Some of the possibilities seem unwise anyway since the mutual fund industry has long sought a special category of registered representatives and the Association has steadfastly refused such requests. This alone, however, should not be a reason for not making some change. If this alternative is decided upon, it seems to me the Association can be sold:

1. by emphasizing the businessmen's approach which is followed by District Committees and the Board of Governors in the application of the Association's rules and in disciplinary proceedings which approach is absent in the case of SECO which is administered by bureaucrats who, for the large part, have never been in the securities business;

2. by pointing out that with the Association there is a level of regulation in between the government and the industry whereas with SECO there is direct governmental regulation in respect to businessmen's ethics;

3. by pointing out that with the Association all of its rules are known since they have been in existence and in operation for many, many years -- with the resultant experience in administration -- and that no one knows what rules SECO will ultimately promulgate or whether they would be comparable to or identical with the Association's, or more

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entire file on the Hamilton matter. This may become moot, however, since HMC has recently told us that it intends to join the Association and it is expected this will be accomplished promptly. A copy of a memo concerning the Hamilton matter is included herein at Tab 5.

stringent as was the suitability rule which SECO has already promulgated, or, even then, how they will be administered;

4. by pointing out that with its experience, the Association handles routine matters expeditiously as contrasted to the present situation existing in SECO which reportedly necessitates months to review simple items of advertising required to be submitted in advance of use by variable annuity members thereof -- such matters are handled in a matter of days by the Association;

5. by pointing out to the potential members that they should not close off all options to sell other funds which would pretty much be the case if they went the SECO route; and

6. by pointing out to them that if they desired a broad distribution of their product they could get it only through the Association. Though all of the companies do not intend to distribute their product broadly, some of them apparently do, and as to those who do not the opportunity would be present if they subsequently changed their policy.

It would be my hope that the Committee at this meeting will arrive at some definitive conclusions on the above matters so a report can be made to the Board in May upon which it can take positive action.

MEMORANDUM OF

DIVISION OF TRADING AND MARKETS

CONCERNING PROPOSED

NASD INTERPRETATION ON DEALING WITH NONMEMBERS

January 5, 1967

The NASD has submitted to the Division for comment a proposed revision of its "Interpretation with Respect to Transactions Between Members and Nonmembers" which raises a number of important questions of law and policy. The present and proposed interpretations relate to Article III, Sections 23, 24 and 25 of the NASD Rules of Fair Practice adopted under Section 15A(i) of the Exchange Act. Section 15A(i) permits a registered national securities association to provide in its rules that "no member . . . shall deal with any nonmember broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."

The principal questions raised by the proposed revision of the NASD interpretation are as follows:

1. Should the NASD be permitted to prevent its members from participating in an offering of securities in which the issuer (a non-NASD member) is also distributing through its employees even when the issuer is not a broker-dealer.[3]

2. Should the NASD be permitted to prevent its members from participating in an offering of securities which is also being distributed by nonmember broker-dealers (in a parallel

[3] See Section 4.B(1) of the proposed interpretation.

arrangement) but where there is no direct contractual relationship (or "dealing") between any member and a nonmember?[4]

3. Should the NASD be permitted to prevent its members from selling shares in distribution to or purchasing such shares from nonmember broker-dealers at the same price (i.e., the public offering price) as the members deal with the public, if the purchasing broker-dealer intends to resell the shares to the public?

We will discuss these questions separately:

1. Since the prohibition of the NASD rule and the specific enabling provisions of the Exchange Act apply only to members dealing with nonmember brokers and dealers and since issuers generally are not within the Exchange Act definitions of "broker" and "dealer" when selling their own shares, it appears that the NASD cannot prohibit members from dealing with issuers that are also distributing their securities directly. When questions along these lines have been raised by NASD in the past, we have consistently taken this position.

The NASD has advised us that in recent years it has had a number of interpretative problems in this area. In some of these instances the issuer has been required to register with the State authorities as a broker or dealer, and the NASD has relied on such registration as a basis for treating the issuer as a "nonmember broker or dealer." We have stated that the Exchange Act definition of this term is controlling.

2. The second question has arisen most frequently in recent years in situations where the issuer, for one reason or another, forms a subsidiary nonmember broker-dealer to distribute

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[4] See Sec. 4.b(5) of the proposed interpretation. While this section is directed only at principal underwriters and applies only to sales of shares of open-end investment company shares, we understand that the same interpretation would also be applied to all members and to conventional firm commitment or best-efforts underwritings.

[3] See Sections 4.b(3) and (5)(ii) and (iii) of the proposed interpretation.

its shares and also attempts to carry out a separate parallel distribution through NASD members. The basic problem with the NASD's prohibiting its members from making such arrangements with the issuer is that here members and nonmembers would not be "dealing" with each other. Section 15A(i) seems to contemplate some direct member/nonmember contractual relationship.

In this connection, the firm of Plaza Securities Corp., an NASD member, recently asked the Commission to review an interpretation given to it by the NASD Board of Governors. Plaza, an NASD member, is a wholly-owned subsidiary of J. E. Stowers & Company which is no longer an NASD member, having resigned its membership at the time of Plaza's formation. Plaza is a principal underwriter of Twentieth Century Investors, Inc., an open-end investment company, and sells the fund's shares through other NASD dealers. Stowers also is a principal underwriter of the fund, but sells the fund's shares through its own sales force. The NASD advised Plaza that the "joining" provision of Section 25 was being violated and that it would be necessary to revive Stowers NASD membership or to take other steps to effect compliance.

In addition to the problem of privity, a second objection to the NASD's proposed position on parallel syndicates might be raised. In these situations the NASD member does not grant any special discount or concession to the nonmember and Section 15A(i) on its face seems to apply only where the member gives such concession or discount. However, paragraph (b)(2) of the NASD rule (adopted in 1939) prohibits a member from joining with a nonmember in a distribution. The NASD, since that time, has interpreted its rule to prohibit members from joining in underwritings where the principal underwriter is a nonmember. An example of this is the IDS situation where the NASD has traditionally taken the position that its members cannot enter into selling group agreements with IDS, a nonmember, to sell Investors Mutual and the

other IDS funds. In such cases any concession that would be granted would flow only from a nonmember to a member rather than from a member to a nonmember.[4] Under the present proposal this NASD view would be extended to situations where there is also no "dealing" between nonmember and member.

3. On several occasions in the past the NASD has said that a member participating in a public distribution may not sell any portion of its allotment to a nonmember at the public offering price where the latter purchases for resale to a public customer at the same price. Here no concession or discount of any kind is granted to the nonmember. In addition, the NASD has taken a similar position where a nonmember underwriter sells (for resale) to a member at the public offering price. (Thus, for example, Bache & Co. would be prohibited from purchasing Investors Mutual shares from IDS as an accommodation for a public customer of Bache.) In either type of situation, the prohibition of Rule 25 is applied even though no concession or discount of any kind is involved. The NASD has rationalized these positions on two grounds -- first, that such arrangements would constitute "joinings" within the meaning of the specific prohibition of Section 25(b)(2) of its rule, and second, that if the Association held otherwise this prohibition could be easily evaded, for example, through grants of reciprocal business or similar offers of an indirect quid pro quo.

It may be questioned whether there is any good policy reason for a flat prohibition against all sales to or purchases from nonmembers at the public offering price. In this regard, for instance, it is arguable that NASD members should be free to arrange for their customers to purchase shares from the so-called "captive organizations" or VALIC's general agents where

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[4] Under Sec. 4.B(2) of the attached draft interpretation members would also be prohibited from acting as an underwriter if the issuer also has a nonmember underwriter distributing another security for that issuer. This provision may be beyond the NASD's authority not only under Section 15A(i) of the Act but also under its own rule.

they (the members), in effect, do so without compensation. We recognize, of course, that in the latter situations the nonmember distributors could offer special inducements for NASD members to assist in public distributions, e.g., by giving them some of the portfolio execution business of the underlying funds or arranging for "give-ups" to them; but it may not be too difficult for the NASD to uncover such indirect concessions and to bring appropriate action.

. . . . . .

It appears that in the past, in construing Section 15A(i) it may have been considered advisable in the public interest to take a fairly broad view of this section in order to have brokers and dealers become subject to the additional regulation provided by the NASD. With the addition of the SECO provisions in 1964, however, this public policy argument no longer has the force it once had. Moreover, Section 15A(i) was included in the Maloney Act for the purpose of encouraging the formation and maintenance of self-regulatory associations of national scope. The NASD achieved its preeminent status with respect to the general securities business many years ago; and NASD members today dominate the channels of initial distribution and the secondary trading markets. Accordingly, there may be no present policy need for as broad interpretations as have been applied in the past.

MEMORANDUM

To: Files

From: Frank J. Wilson

Date: February 8, 1967

Re: February 2, 1967 meeting with SEC personnel --
Memorandum on Dealing With Nonmembers

A meeting was held at the SEC on Thursday, February 2, 1967, at 10:00 a.m. concerning the interpretation on dealing with non-members, with the following members of the Commission's staff and Association representatives present:

Moskowitz	Derrickson
Mylod	Welch
Pollack	Moulden
Block	Gilleran
Rappaport	Brummett
	Wilson

The Commission's memorandum of January 5, 1967, was discussed in detail. The Commission representatives expressed their opinion that there was no legal basis whereby the NASD could prevent:

1. Its members from participating in an offering of securities by an issuer which also was distributing the same issue through its officers and employees even when the issuer is not a broker/dealer;
2. Its members from participating in an offering of securities which is also being distributed by non-member broker-dealers, in a parallel

arrangement, where there is no direct contractual relationship, or dealing, between any member and non-member; and

3. Its members from selling shares in a distribution to or purchasing such shares from non-member broker-dealers at the same price (i.e., the public offering price) as a member deals with the public, if the purchasing broker/dealer intends to resell the shares to the public.

The staff was of the opinion, however, that the NASD had a legal basis for preventing its members from

1. Participating in an offering of securities which is being distributed by an affiliate or subsidiary non-member broker/dealer of an issuer as was the situation in the several Michigan cases which were before the Board several months ago; and

2. Participating in a distribution of securities in a situation such as existed in the Plaza Securities Corp. --J. E. Stowers & Company relationship, the reasoning being that in that situation there was a connection between the two. They indicated that they believed the NASD could prevent its members from participating in any case where there is such a direct or indirect connection.

To review the Plaza situation, Plaza, an NASD member, is a wholly owned subsidiary of J. E. Stowers & Company which is no longer an NASD member having resigned its membership at the time of Plaza's formation. Plaza and Stowers are both principal underwriters of 20th Century Investors, Inc., an open-end investment company. Plaza sells the shares through other NASD dealers. Stowers sells the shares through its own sales force.

Since Plaza is wholly owned by Stowers, there is a connection between the two and the Commission staff indicated that the situation was such that this would constitute an evasion of the Association's Rules and wherever that existed, be it direct or indirect, the Association was justified in preventing its members from participating in the distribution.

Mr. Block also indicated that his opinion was that Section 25(b)(2) of the Association's Rules is probably also illegal and contrary to the statute but that since it has been on the books for so long he wouldn't raise the question. His reasoning is that Section 15A(i)(1) of the 1934 Act prescribes only that the rules may provide that no member shall deal with any non-member "except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." He argues that this would not prevent a member from joining with the non-member by selling to him for subsequent distribution to the public as long as he charged the public offering price.