

THE NASD -- ORIGINS, RECENT DEVELOPMENTS AND  
FUTURE GOALS

## PREFACE

The National Association of Securities Dealers, Inc. (“NASD”) is unique not only in the securities industry but perhaps in the history of self-regulatory organizations founded under the laws of the United States.<sup>1</sup> On the one hand, it is a trade association founded to promote the interests of the investment banking and securities business,<sup>2</sup> and to provide a medium for broker-dealer members to place their case before the Securities and Exchange Commission and before Congress. There are a great many securities industry trade associations operating on behalf of their own particular memberships, often with headquarters in Washington, like the NASD, which provide coordinated access to the legislative process for their members. The NASD, on the other hand, is made unique by statement number five of its charter, regarding the purpose of the Association: “To establish, and to register with the Securities and Exchange Commission, as a national securities association pursuant to Section 15A of the Securities Exchange Act of 1934, as amended, and thereby to provide a medium for effectuating the purposes of said section.”<sup>3</sup>

The NASD in placing itself under Section 15A of the Exchange Act thereby vests itself, its rules and its regulatory actions, insofar as these carry out the statutory purposes of the Act, with the authority of federal law. No other trade association has such authority.

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<sup>1</sup> Homer V. Cherrington, “National Association of Securities Dealers,” Harvard Business Review (November 1949), p. 741: “Never in the history of American business has there been such an experiment in self-regulation as that which has prevailed in over-the-counter securities markets since the organization of the NASD in the summer of 1939.”

<sup>2</sup> “Certificate of Incorporation,” NASD Manual, p. 1021.

<sup>3</sup> Ibid., pp. 1021-1022.

Although every broker-dealer and securities salesman knows of it, and hundreds of thousands of securities industry personnel have taken examinations administered by the NASD, the Association is not well known to the general public. Even the investing public has not, except in rare instances, heard of the organization which was founded to protect its interests, and whose stated corporate purpose is:

To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors.<sup>4</sup>

To carry out its duties of self-regulation, the Association is aided by more than 300 volunteer members from the industry who donate their time and expertise to the task, and by a large staff located in the executive headquarters in Washington and in fourteen district offices throughout the country. The volunteers on the Board of Governors and the many committees, and the paid staff supported by member assessments, obviously represent a very large savings to the taxpayer. It was the decision of Congress in 1938 to set up legislation under the Maloney Act to enable the over-the-counter securities industry to regulate itself. The NASD is by common consensus the fulfillment of the intent of that legislation. Except in the opinion of those whose self-interest is patently served by gainsaying them, the following words of Senator Harrison A. Williams, Jr. express the common reaction of legislators and the securities industry: “In my view the delegation of government authority to the NASD has worked well, and the Association by and large handled its public trust in an exemplary manner.”<sup>5</sup>

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<sup>4</sup> Ibid., p. 1021.

<sup>5</sup> 35th Anniversary Proceedings of the Maloney Act (Washington, D. C., 1973), p. 30.

Of the NASD and self-regulation, President Gordon S. Macklin had this to say:

First and foremost we believe in self-regulation thoroughly aware of the vulnerability and possible confusion of self-regulation with self-interest. I can tell you from being on the firing line that self-regulation harnesses a unique expertise that money can't buy. The experience with our Board and our various committees is truly gratifying, where you can tap the top talents in the country, at a minimum of cost, to address the complex problems that come before the NASD. To me it is the most satisfying part of any NASD work.<sup>6</sup>

I wish to acknowledge with gratitude the help given me by Professor Jeremy L. Wiesen of New York University Graduate School of Business Administration, who suggested this topic and the general approach; by Robert H. Lynch, Esquire, Counsel of the New York District Office of the NASD, who provided rare published material and a critique of the work in progress; and by my wife, Charlotte, who typed the manuscript, made many useful suggestions, and provided the necessary encouragement to complete this work.

August, 1974

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John D. McGowan

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<sup>6</sup> Ralph P. Coleman, Jr., "The NASD Story," Over-the-Counter/Securities Review (April 1972), p. 4.

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FOR CHARLOTTE

## CHAPTER I

### STATEMENT OF THE PROBLEM, DEFINITIONS, AND METHODS OF RESEARCH

#### Statement of the Problem

More broker-dealers belong to the NASD than belong to the exchanges; more securities issues are quoted in the over-the-counter markets than are listed on the exchanges; hundreds of thousands of securities salesmen have taken qualifying examinations administered by the Association; it has been in existence for over thirty-five years--and yet the National Association of Securities Dealers, Inc. is not well known. The market which it regulates is the medium through which many small companies--some of which turn out to be great companies--first begin to raise capital. And, in 1974, the NASD appears very important to Congressional and SEC considerations of the future central market, as shall be shown in a later chapter.

The problem in writing about the Association at length is the general unavailability of printed sources of its history, and the scattered location of the sources available.

The Association has, from the beginning of its operation in 1940, published periodically the NASD News. A great deal of material may be found in it, but lack of a topical index hinders its use as a research tool. In 1958 Congress asked the Association to report on its operation twenty years after passage of the Maloney Act. This gave rise to the valuable document known as "History of the National Association of Securities Dealers, Inc., Its Activities, Membership Data, Sanctions Imposed, Members Expelled, Financial Statements, Liaison and Supervision by SEC from 1936 to November 30, 1958." It was issued by the House Subcommittee on

Legislative Oversight in the 85th Congress, 2nd Session in 1959. The authors by no means intended the document to be more than a summary of data. No attempt at interpretation has been made, and it is not a history in the more complete sense of the word.

#### Lack of Available Current History

Thus, no attempt has been made up to the present time to write the NASD history, nor has any current work been written to combine a narrative of the NASD's origins, recent developments and future goals. Nor is this present paper intended to be a complete history. It is an introduction to such a work. It is a key for anyone wishing to open the door to a full history of the NASD. Only published documents are used. It is hoped that all of the major published documentary sources of the Association's history are included in the bibliography, that all of the major accomplishments of the Association are at least noted, and that enough statistics are presented to the reader unfamiliar with the NASD to give him a good basic overview of its purpose, its organization and its accomplishments.

#### Growing Importance of the NASD in the Securities Industry and Consequent Need for a Study

The NASD provides both the self-regulatory function for the over-the-counter securities industry and a market-promotion function. Growth in both of these fields had become so pronounced that in 1972 it was proposed by the Subcommittee on Commerce and Finance of the House of Representatives that the Association assume all responsibility in the securities industry for conducting regulatory examinations of broker-dealers, both non-exchange firms and exchange firms.<sup>7</sup> Regarding its other function, promotion of markets, Senator Harrison A. Williams, Jr., Chairman of the Senate Securities Subcommittee, recommended that the National Association of Securities Dealers Automated Quotations system (NASDAQ) should be the new

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<sup>7</sup> Securities Industry Study (House of Representatives, 1972), p. 56.

central market facility for the dissemination of quotations in listed stocks as well as over-the-counter or unlisted stocks.<sup>8</sup> The need for a general survey of the Association, therefore, seems very timely.

Definition by Function: The Reason for Being of the NASD

Why did Congress in 1938 pass legislation, known as the Maloney Amendment to the Securities Exchange Act of 1934, to provide for the registration with the Commission of national associations of broker-dealers? The answer is supplied by a quotation from the congressional committee that considered the Maloney Amendment:

The problem of regulation of the over-the-counter markets has three aspects: First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in this 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; and third, 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.<sup>9</sup>

The alternative to the Maloney Act would be minute detailed government regulation, a pronounced expansion of the SEC, and, of course, a greater burden on the taxpayer. Congress chose the path of "cooperative regulation"<sup>10</sup> with the government exercising supplementary powers of direct regulation, amounting to oversight of the regulating bodies.

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<sup>8</sup> 35th Anniversary of the Maloney Act, Proceedings, p. 30.

<sup>9</sup> Quoted in Leo M. Loll and Julian G. Buckley, The Over-the-Counter Securities Markets, 3rd ed. (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1973), pp. 274-275.

<sup>10</sup> Senate Committee quoted in Loll & Buckley, op. cit., p. 275.

Self-regulation in government was not a new concept. The Federal Trade Commission had, since approximately 1912, encouraged business enterprises to form associations and to develop business conduct codes.<sup>11</sup> Self-regulation in industry is a concept that has grown parallel with the increase in government regulation of many fields.<sup>12</sup> The federal government is active in the aeronautics, advertising, mining, manufacturing, food and drug, transportation and other industries. State governments are active in regulating insurance and banking, etc. Municipal governments supervise retail business, construction, restaurants, etc. It is always easier for the government regulator at whatever level to deal with a trade association in addition to dealing with each individual firm in the industry. The NASD is unique, however, as a self-regulator, in that its rules are vested with congressional authority and its disciplinary actions carry the sanction of the federal securities laws.

“...just and equitable principles of trade”<sup>13</sup>

The cornerstone of the NASD’s Rules of Fair Practice rests on the pledge of its members to observe high standards of commercial honor and just and equitable principles of trade. It was the opinion of SEC Commissioner George C. Mathews, who in 1938 testified in favor of the Maloney Act, that:

There is a vast field for the control of ethical practices in this business which is not a field which the government can very well occupy. An association of this sort, if it is successful, must be able to control the practices of its members which in the language of the stock exchange rules

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<sup>11</sup> Homer V. Cherrington, “National Association of Securities Dealers,” Harvard Business Review (November 1949), p. 741.

<sup>12</sup> See: Ralph L. Smith, Self-Regulation in Action; the Story of the Better Business Bureaus 1912-1962 (New York, 1961); Rush C. Butler, The Self-Regulation of Industry (Chicago, 1929); Verne E. Burnett, Self-Regulation of Advertising (American Association of Advertising Agencies, 1950).

<sup>13</sup> Section 1, Article III, NASD Rules of Fair Practice.

are inconsistent with just and equitable principles of trading. I think if we have any hope that the securities business is to be put on that high professional plane we must look to help from within the industry, and, I think, organized help.<sup>14</sup>

Commissioner Mathews said that the voluntary association provided for by the Maloney Act would, he hoped, “largely take over the problem of regulation of the business, subject to the safeguards” of Commission oversight. These associations would have to be “comprehensive enough and vigorous enough” to assure that members have a proper standard of financial responsibility.<sup>8A</sup>

### Scope and Limits of This Study

Historical Approach: Origins, Recent Developments and Future Goals. The aim of this paper is to present a brief historical outline, narrative and bibliography of the NASD to be used as a sort of handbook by anyone interested in pursuing some facet of the Association’s history. The chapter on Origins covers the years 1934 to 1964, beginning with the attempts of the Investment Bankers Association under the NRA to found an association, and ends in 1964 when the SEC published its massive seven volume study of the securities markets in which profound changes were recommended and the Securities Exchange Act of 1934 was amended.

The chapter on Recent Developments covers the years 1964-1974, when the NASD began its own self-study and started work on projects which became today’s National Association of Securities Dealers Automated Quotation System (NASDAQ) and National Clearing Corporation (NCC). At the suggestion of the SEC, the Association expanded its staff. It participated in congressional hearings on the planning for the future central market, and received high marks from Congress for its role of self-regulator of the over-the-counter securities

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<sup>14</sup> Loll & Buckley, *op. cit.*, p. 275.

<sup>8A</sup> SEC Release No. 34-3734, September 14, 1945.

industry, to the point that the NASD was suggested as the sole broker-dealer inspection agency in the future central market.<sup>15</sup> Planning is underway for the role of the Association in the future central market, and through its executive office in Washington it maintains communication with Congress and the SEC on the whole range of topics for which it is responsible to its membership under Section 15A of the Securities Exchange Act of 1934.

The chapter on Future Goals presents some of the plans of the Association for its own future and some of the pending congressional legislation concerning the future central market.

#### Recent Statistics: Present Status of the Association

The number of member firms at the end of 1973 was 3,665, down 18% from the 4,470 of 1970. Registered Representatives numbered 208,989, up from the 197,570 of 1970. NASD qualification exams administered in 1973 were 46,312, down 27% from the 63,653 of 1970. Income for 1973 was over \$12 million, about half of which was derived from member assessments. Expenses were \$345,000 less than income. The largest expense, over \$8 million, is for salaries and employee benefits.<sup>16</sup>

“The Association conducted 3,737 regular and special examinations of members’ main offices in 1973. Three hundred and twenty-two inspections of branch offices were also undertaken. As a result of the examination program, 384 Formal and Summary Complaints were filed, and 93 Letters of Admission, Waiver and Consent were accepted. Disciplinary actions during 1973 resulted in the expulsion of 61 firms, the barring of 183 individuals and the suspension of 49 firms and 69 individuals.”<sup>17</sup>

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<sup>15</sup> House Securities Industry Study, 1972, p. 56.

<sup>16</sup> 1973 NASD Annual Report.

<sup>17</sup> Ibid., p. 5.

Income in 1973 from fines and costs collected, but not necessarily levied in 1973, was \$471,910.

### Methods of Research Used in This Study

Use of Library Facilities. A search was made of the New York University Graduate School of Business Administration Library and Library of Congress card catalogues for articles or books on the NASD. Also reviewed were: the Wall Street Journal Index and The New York Times Index, the Periodicals Index and Business Periodicals Index, American Doctoral Dissertations and Dissertations Abstracts International. No one book, such as “A History of the NASD”, was found.

NASD and U. S. Government Publications. Most of the material for this work was gathered from these sources. The NASD publishes material on new developments and has many pamphlets available for NASDAQ, NCC, Registered Representatives, and so on. The Annual Reports, NASD News, and Notices to Members are all valuable sources.

The Securities and Exchange Commission and both Houses of Congress publish their own studies concerning the NASD, often included in studies of the overall securities industry. The items used are listed in the bibliography below.

No access was had to the unpublished records of the NASD. Important among these would be minutes of Board of Governors meetings, correspondence and internal memoranda.

Consequently, this work is to be considered a first attempt to assemble the sources of information and to point out important milestones on the way from the 1933 beginnings to the indications of future goals to be attained, looking from the vantage point of 1974.

## CHAPTER II

### ORIGINS, 1933-1964

#### The Investment Bankers Association Attempts Self-Regulation under the National Recovery Administration (“NRA”) 1933-1935

In the year 1933 there was great need to restore public confidence in the securities industry. Among the chief causes of a decline in public confidence had been the excessive floating of new securities issues by investment bankers during the late 1920's. The culmination of these questionable securities business practices came when the market crashed in October 1929.<sup>18</sup>

The extent of the decline may be seen from the following data: in no year from 1919 to 1931 had investment banking annual volume ever been less than \$4 billion. In 1929, the peak year, volume was \$11.5 billion. However, in the years 1932-1934 volume was approximately \$1 billion.

In response to this debacle of the securities industry, the new federal administration took severe remedial measures. One of these, directly affecting the industry, was passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the founding of the Securities and Exchange Commission. Another measure that indirectly affected the securities business

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<sup>18</sup> Code of Fair Competition for Investment Bankers (Investment Bankers Code Committee, Washington, D. C., 1934), p. 86.

was passage of the National Industrial Recovery Act (“NIRA”) and creation of the National Recovery Administration, one of whose aims was the formation of codes of fair competition by representative trade associations of different industries.<sup>2</sup>

Mr. Robert E. Christie, President of the Investment Bankers Association (“IBA”), at hearings before the NRA on March 15, 1934, expressed his views on the “Code of Fair Competition for Investment Bankers.” The new Code addressed itself primarily to the underwriting and distribution of new securities with much emphasis on financial disclosure by the issuer. Other sections were directed to reform of retail sales, minimum qualifications for salesmen and restrictions on relations between investment bankers and investment companies.<sup>3</sup>

On March 23, 1934 Mr. Hugh S. Johnson, Administrator of the NRA, on behalf of the IBA, submitted the “Fair Practice Amendments to the Code of Fair Competition for Investment Bankers” to President F. D. Roosevelt for approval. Johnson said that the Code provisions “constitute a remarkable document” and were aimed at eradicating past abuses and at establishing practices which will justify public confidence in the investment industry.<sup>4</sup> In his letter of transmittal to the President, Johnson was careful to point out that the IBA is the only national association of securities dealers.<sup>5</sup>

Founded in 1912, the IBA had for years been the only national custodian (unofficial) of standards for the over-the-counter securities industry. Until 1934 and the inclusion of the Code under the official mantle of the NRA, the IBA’s rules lacked the force of law. The new federal

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<sup>2</sup> Ibid., p. 43.

<sup>3</sup> Id.

<sup>4</sup> Ibid., p. 2.

<sup>5</sup> Ibid., p. 3.

act, the NIRA, made it possible to promulgate the Code with the authority of official, legal sanction. For the first time the over-the-counter markets would be governed by statutory law. The Code, amended and approved in 1934, called for higher standards in the securities business than had ever been known: continuous disclosure of facts by the issuing corporations as long as their securities are outstanding, reforms in high pressure sales tactics, disclosure of self-interest by salesmen in the securities they are selling, and, most important of all, provisions for administration and enforcement of the Code under sanction of the NRA.<sup>6</sup>

#### Interim Self-Regulation of the Over-the-Counter Securities Market, 1935-1939

The NRA had been the most dramatic development along the lines of federally encouraged self-government. The Code of Fair Competition and the Code of Fair Practice Amendments sponsored by the IBA, encouraging as they were, were to be short-lived. With the decision of the Supreme Court<sup>6A</sup> in the Schechter Case, the NIRA was declared unconstitutional. This meant that the IBA Codes drawn up and passed in 1934 were no longer clothed with government authority.

Nevertheless, the IBA decided to continue its experiment in self-government without the legal backing of the federal government. The committee, formed in 1933 to draw up the Code of Fair Competition and the Code of Fair Practice Amendments, was called the Investment Bankers Code Committee. Upon the demise of the NRA in 1935, this became the Investment Bankers Conference Committee. And this, in turn, was succeeded by the Investment Bankers

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<sup>6</sup> Ibid., pp. 45-46.

<sup>6A</sup> Schechter (A.L.A.) Poultry Corp. v. United States, 295 US 495, 55 SG 837, 97 ALR, 79 L ed 1570.

Conference, Inc.<sup>7</sup> It was this last organization, incorporated under the laws of Delaware in October 1936, which drew up the plans for what would become today's NASD. The Conference in cooperation with the SEC drafted a bill and presented it to Congress in October 1937. This Bill emerged as the Maloney Act of 1938 (Section 15A of the Securities Exchange Act of 1934).

The SEC felt strongly the lacuna of self-regulatory authority in the over-the-counter segment of the industry and so urged that the Investment Bankers Code Committee be kept together until legislative authority could be worked out through industry and congressional cooperation.<sup>8</sup>

A canvass of Investment Bankers Conference, Inc. ("IBC") membership revealed that 90% of all registered broker-dealers indicated their approval of code continuance, and backed their vote with financial support. In 1936 the newly formed IBC had 1,617 members.

### The Maloney Act

Besides the IBC there existed a half-dozen other regional broker-dealer associations. Representatives from all of these aided in drafting legislation introduced in the Senate and passed as the Maloney Act Amendment on June 25, 1938. However, the Maloney Act provided only the opening for a national securities association to register with the SEC under the 1934 Act. The next step was to prepare the IBC with SEC aid to register under the amendment. The Registration was filed July 18, 1939, and became effective on August 7, 1939. Registration of

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<sup>7</sup> Homer V. Cherrington, "National Association of Securities Dealers," Harvard Business Review (November 1949), p. 741

<sup>8</sup> History of National Association of Securities Dealers, Inc. (U.S. Government Printing Office, Washington, D.C., 1959), p. 2. "Without legislative authority, however, the problem of enforcement of self-regulation was an impossible one. Therefore, the Securities and Exchange Commission urged that the Code Committee, which was the administrator of the IBC, be kept together while the industry and the Commission sought such legislative authority."

other national associations has always been open, but the NASD is the only one so far to have registered.

The original Maloney Act required that membership be kept open to all brokers and dealers subject only to certain exceptions based on past conduct. This was in reaction to the clubbiness of the exchanges. As shall be seen, the stipulation that entry to association membership be kept as open as possible tended to be modified with time. In the early 1970's when many firms were failing due in part to fraudulent management, pressure was exerted from both the SEC and the industry for tighter entry standards.

### Internal Organization

The By-Laws divide original jurisdiction into 13 districts,<sup>9</sup> and in each district there is a district committee which acts as the agent for the Board of Governors in that area. The districts also elect the Board of Governors which Board performs policymaking functions. An advisory council made up of the 13 district committee chairmen aids the Governors in administration at the district level, thus ensuring the democratic basis of the Association required by the Maloney Act.

District offices are located in Seattle, San Francisco, Los Angeles, Denver, Dallas, Kansas City, New Orleans, Atlanta, Chicago, Cleveland, Washington, Philadelphia, New York and Boston. (District 2 has offices at both San Francisco and Los Angeles.)

### Rules of Fair Practice

Article seven of the By-Laws continues the Fair Practice Amendments to the Code of Fair Competition for Investment Bankers adopted in 1934 under the NRA. Article seven, based on Section 15A of the '34 Act, provides the authority for the NASD Rules of Fair Practice.

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<sup>9</sup> Ibid., p. 4. Originally there were 14 districts.

Section 1 of the Rules sums up the spirit of the NASD and of its predecessor, the Investment Bankers Code Committee, in these words, “A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.”<sup>10</sup>

The Maloney Act, Section 15A(b)(7) stated that the rules of the Association are designed:

. . . in general, to protect investors and the public interest, and to remove the impediments to and perfect the mechanism of a free and open market, and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

In the years since it was founded, the Association has added to the Rules until in 1974 they number thirty-two, with three more under consideration. Article III, Section 1 has undergone extensive commentary by the Board of Governors, particularly in the domain of advertising and corporate financing. The latter was the original principal domain of the Investment Bankers Code Committee. By 1958 there were twenty-eight Rules.

#### Financing the NASD

Consistent with the philosophy of a self-regulatory body, no government monies support the Association. It is a member organization supported by the broker-dealer community which it serves. The By-Laws provide for a variety of assessments annually by the Board of Governors to cover operating expenses. No profits accrue to the Corporation. There is a membership fee, fees for registered personnel, for underwritings, gross sales and for the filing of documents connected with an underwriting.

A budget or schedule of assessments is filed with the SEC each July for the coming fiscal year (October 1-September 30).<sup>10A</sup> If the Commission finds that the budget is inequitable in its

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<sup>10</sup> Rules of Fair Practice, Article III, Section 1, CCH, NASD Manual, paragraph 2151.

<sup>10A</sup> History of NASD, 1959, op. cit., p. 6.

allocation of expenses, it may disapprove it and ask that revisions be made. Expenses are incurred in operating the executive office, district offices, the Board of Governors and its committees, and all the expenses of district committees.

It should be noted that the Board of Governors and the district committees serve without pay, only their out-of-pocket expenses being reimbursed. Otherwise the cost of maintaining the Association would be impossible to meet.

#### Significance of Membership in the NASD

A broker-dealer member of the NASD is subject to all provisions of such membership, such as adherence to the Rules of Fair Practice, the Code of Procedure for Handling Trade Practice Complaints, the Uniform Practice Code and the Code of Arbitration Procedure. Other broker-dealers know where they stand with an NASD member. They know they have access to standing committees and staff in disputes, and will not have to undergo expensive legal fees to untangle routine questions of trade practice and of customer relations. If a member has been expelled for cause by the Association, his business will suffer because of this. He will “lose prestige with his competitors and with investors who have knowledge of what has happened.”<sup>11</sup>

More important for the non-member is the loss of special advantages accorded to members in their dealings with other members such as concessions in the sale of mutual funds, participations in underwriting activity and “the right to buy any outstanding security from any member at a price that is less than that at which it is made available to the public in general.”<sup>12</sup>

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<sup>11</sup> Cherrington, *op. cit.*, p. 745.

<sup>12</sup> *Ibid.*, p. 745.

### Enforcement of Association Rules

Article IV, Section 5 of the Rules of Fair Practice provides the Association with the authority to investigate the books and records of its members or to require members to provide reports to the district committees. Refusal to comply with this rule would constitute grounds for suspension from membership.<sup>13</sup>

The progress of enforcement of its rules was at first by trial and error. Two basic factors always had to be considered: one, reasonable assurance on the part of the Association that the membership was operating in compliance with its rules and regulations; and, two, only a certain limited budget was available from assessments for investigations.

After registration in 1939, the NASD was sufficiently organized in 1941 to begin its enforcement program. In some districts certified public auditors were employed; in others, teams of association examiners were employed. The results of this experiment disclosed that it would be prohibitively costly to examine every member by personal visits of association staff. A decision was made to conduct part of the examination by means of questionnaires. The most common problems in these early days were related to the sale of securities to customers at unfair prices, misunderstanding of rules by hypothecation of customer securities, and failure to make and maintain proper books and records.

Meanwhile, due to World War II, lack of manpower perforce led to extensive use of the questionnaire instead of personal examiner visits. Experience soon taught the predictable result, that the questionnaire is of limited usefulness except in determining fair markups on securities sold by members to the public. Churning of customers' accounts, failure to properly supervise

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<sup>13</sup> NASD Manual, paragraph 2205.

salesmen's activities, improper recommendations to customers, etc., escaped the questionnaire approach.

It was, therefore, decided that as competent manpower became available, the examiner staff would be expanded to the point where it could examine one-third of the membership on an annual basis. Up to 1958, analysis of disciplinary actions involving improper treatment of customers revealed that such rule infractions tended to be prevalent in firms where capital was small or inadequate.<sup>14</sup>

As a result, in May 1942 the Board of Governors adopted a rule requiring \$5,000 minimum capital for general securities firms and \$2,500 minimum for firms not handling customer funds or securities. The membership voted this rule in, but it was subsequently disapproved by the SEC. The Association, under Section 1, Article III of the Rules of Fair Practice, has been able to take action in cases where members were found to be insolvent. Later the SEC did approve a minimum net capital rule, which by 1974 required \$25,000 minimum for a general securities firm.

An important area of concern is the 5% markup policy of the Board of Governors. Available statistics in 1943 disclosed that most OTC transactions involved markups of less than 5%. This decision does not constitute a hard and fast rule. Many factors are involved, such as size of the order, availability of the security, number of dollars involved in the transaction, and cost of the securities by individual unit.

Another area of concern in enforcement was the inability of member firms to control their salesmen. As a result, the Board of Governors amended the By-Laws to require all salesmen to

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<sup>14</sup> History of National Association of Securities Dealers, Inc., loc. cit., pp. 7-8.

be registered with the Association as registered representatives of member firms. This move placed the salesmen under the same obligations as the firms to observe the Rules of Fair Practice.

### Examination Procedures

There are three basic goals to be achieved in the examination procedure: first, to disclose violations of Association rules; second, to obtain statistical information; and third, to pursue the educational aspect of the Association's work.<sup>15</sup>

Standardization of the examination procedures has slowly evolved, but the field examination of member firms can never become a thoroughly mechanical process. Originally the NASD alone had responsibility for financial conditions and customer funds and securities. Subsequently, the SEC adopted the capital ratio rule and the requirement for the filing of annual financial reports. Inspection for compliance with these rules is now part of the Association's program.

The examiner visits the firm on a surprise basis, and with the aid of a field questionnaire reviews the following points, among others. An interview with firm principals reveals the nature of the firm's business and its operation. New issues, unlisted securities, mutual funds or other special product type securities may be among the products sold by the firm. Commission charges, discretionary accounts, safekeeping customer securities, sales methods, correspondence, supervision of salesmen and records, borrowings, accuracy and currency of records, experience and competence of personnel, markups, profit ability, advertising, etc., all come under the examiner's purview. Examiners must also check for certain disclosures on the part of the firm to its customers, such as whether the firm principals have large interests in the issues dealt in, whether the issues are shell corporations, whether the principals are officers of these issuing

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<sup>15</sup> Ibid., p. 8.

corporations, or whether the firm was the underwriter of issues it recommends in its sales literature. All of these examination areas are mandated by NASD Rules or SEC Rules.

The Association's examinations are not a substitute for a financial audit, but they do cover all phases of the securities business, and are adequate to determine whether a business is being conducted in accord with "high standards of commercial honor and just and equitable principles of trade." This is the basic purpose of the Association.<sup>16</sup>

### Disciplinary Procedures

Provisions are included in the 1934 Act and in the Association's rules to provide appropriate penalties for violations of the Rules of Fair Practice: expulsion, suspension, fine and censure, among others. However, a fair and orderly procedure carried out by the District Business Conduct Committees, made up of the members themselves, assures the alleged violator of a full hearing. Specific charges must be brought;<sup>17</sup> opportunity must be given to defend against the charges; a record of the hearing must be kept; and any final determination must set forth the full particulars of the complaint and the proceedings. Appeal from any district decision may be made to the Board of Governors. Further appeal from the Board of Governors' decision may be made to the SEC.<sup>18</sup> The Commission may modify or diminish the decision but not

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<sup>16</sup> It is interesting to note the observation of Homer V. Cherrington, Professor of Finance at Northwestern University. He sums up his assessment of NASD history, 1939-1949, with this conclusion: "(The small number of SEC and NASD actions in the late 1940's leads to the conclusion that) the Association has rendered praiseworthy service to our American economy by helping, in an aggressive manner, to foster 'high standards of commercial honor,' to prevent 'fraudulent and manipulative acts and practices,' and, in general, to protect investors against that unscrupulous fringe in the securities business that knows no law save the law of undisciplined self interest. In other words, this experiment in self-regulation can be judged a success." Op. cit., p. 759.

<sup>17</sup> History of NASD, p. 11.

<sup>18</sup> NASD Code of Procedure for Handling Trade Practice Complaints, Section 20.

increase it. Finally, Commission action may be appealed to the Federal Courts up to the Supreme Court.

Complaints may arise in various ways. Routine examinations by the Association staff may uncover alleged violations causing the District Business Conduct Committees to issue complaints against a member firm. Customers may submit complaints which upon investigation may or may not have merit sufficient to cause the District Committee to issue a complaint. Peer broker-dealers may also submit complaints to be investigated by the District Committee.

The Code of Procedure for Handling Trade Practice Complaints, a valuable part of the Association's Rules, was adopted in the By-Laws as a means of administering and enforcing the Rules of Fair Practice.<sup>19</sup> In practice, this code of procedure has worked well because its administration is in the hands of the local district committee whose members will be familiar with the practices in the over-the-counter industry in that area, as well as what is regarded as the best practice in the industry as a whole.<sup>20</sup>

#### Uniform Practice Code

Article XIV of the By-Laws authorizes the Board of Governors to adopt a uniform practice code and amendments thereto. Prior to the founding of the NASD, OTC transactions were handled on a very informal basis.<sup>21</sup> The national exchanges had been promulgating delivery rules and listing requirements for many years prior to the Association's founding in 1939, but the OTC market was so unstructured that there was frequently doubt as to the actual terms of the contracts. The Board of Governors recognized the need of a Code for this area of

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<sup>19</sup> By-Laws, Article VII, Section 3.

<sup>20</sup> History of NASD, p. 12.

<sup>21</sup> Ibid., p. 15.

activity from the very outset in 1939. The problems before the Committee appointed to draft the Code were so complicated that the Code was not ready until August 1, 1941. Since its adoption it has been effective in removing many obstacles from the smooth operation of the OTC securities industry.

### Quotations

In September 1941 the Association's national quotations committee adopted policies to be followed by the various districts in newspaper publication of stock quotations.<sup>22</sup> In 1943 the SEC took exception to the adopted policy, and in October 1944 the Board of Governors authorized funds to revise the old quotation policy. The new policy provided that listed quotations be actual prices at which some dealer was willing to buy or sell at the time the quotations were recorded.

In January 1947 the Wall Street Journal published 450 stocks on a weekly basis. In 1958 the Journal was carrying a 360-stock national list on a daily basis. These were humble beginnings compared with the 1974 quotation services available on the National Association of Securities Dealers Automated Quotation Services, but they were an advance over what had obtained previously.

### The Development of Some of the Early Rules and Policies

Controlling Prices during Distribution. NASD rules and regulations have been built up by appeal decisions as well as by canvassing the opinion of the members. In 1939 the Public Service Company of Indiana sold an issue of \$30 million of 4% mortgage bonds to a group of 67 underwriters and nearly 400 dealers. Except for a concession of 1/4 of 1% allowed NASD members, all broker-dealers involved were required not to resell the bonds at a price below the

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<sup>22</sup> Ibid., p. 16.

initial public offering price except as a result of changes in the public offering price or as a result of the removal of “price restrictions after the initial public offering, by reason of changes in market conditions.”<sup>23</sup>

Great difficulty was encountered in selling these bonds. The average time required to sell electric and gas issues in the years 1938-1940 was 11 days. It took 103 days to sell the PSCI bonds. As a result, many dealers made price concessions in violation of their agreements.<sup>24</sup> NASD complaints were issued and punishments were meted out. Subsequently the SEC reviewed six selected cases.

The Commission took the view that (1) “the mere making of agreements containing provisions for a fixed offering price, price maintenance and stabilization is not per se unlawful.”<sup>25</sup> Consequently, (2) the leading underwriters could have brought suits for breach of contract against the dealers who violated the terms of the agreement. But, (3) there is nothing in the Maloney Act which gives the NASD authority to discipline members who violate agreements to maintain prices in a security distribution. On the contrary, Section 15A(b)(7) of the 1934 Act forbids the Association “to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commission, allowances, discounts or other charges.” Therefore, the penalties were set aside.

Protection of Markets. As of 1949 the Association had acted to protect the over-the-counter markets by intervening before the SEC in eleven instances where exchanges had applied

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<sup>23</sup> SEC Release 34-3700.

<sup>24</sup> Cherrington, op. cit., p. 752.

<sup>25</sup> Ibid., p. 752.

for unlisted trading of OTC stocks. In eight cases out of the eleven, the applications were denied.<sup>26</sup>

In 1941 the Association adopted the rule that virtually obliges investment companies to employ members as underwriters. “The underwriter, in turn, is deprived of the right of selling to a non-member broker or dealer at a price below the public offering price.”<sup>27</sup>

In 1949 the International Bank for Reconstruction and Development promoted legislation whereby its bonds should be exempt from the 1933 and 1934 Securities Acts, and national banks should be permitted to deal in these bonds. Further, the Bank desired that national banks be allowed to deal in bonds guaranteed by the International Bank. This would have opened the door to trading in the securities of foreign governments and corporations by national banks. The Association did not object to exemption of the International Bank bonds from securities legislation, but it did object to exemption of issues guaranteed by the Bank. As a consequence, the plan as originally conceived was modified and the Bank’s exemption does not apply to guaranteed issues.<sup>28</sup>

### Conclusion

The history of the Association from 1933 to 1964 centers around the legislation of the Maloney Act and the subsequent legislation and regulation arising from situations such as the Public Service of Indiana case. In 1963, the SEC began its massive study of the securities industry. The results and recommendations of this study affected both the exchanges and the

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<sup>26</sup> Ibid., p. 753.

<sup>27</sup> Ibid., p. 753.

<sup>28</sup> Ibid., p. 754.

NASD. Consequently, this chapter on Origins ends at this point. Coincident with the division of these chapters is the career of the first Executive Director of NASD, Wallace Fulton (died 1974).

Mr. Fulton became the Director in 1939 and retired in 1964 after 25 years of service.

Succeeding Fulton was Robert Haack, later President of the New York Stock Exchange.

Beginning with Mr. Haack and continuing with his successors, the Association staff has grown both in numbers and in importance. The chapters on Recent Developments and Future Goals will give at least in outline some of the more current accomplishments of the NASD.

## CHAPTER III

### RECENT DEVELOPMENTS, 1964-1974

#### The SEC Report of 1963

It was in response to a request from Congress that the SEC undertook its study of the securities markets and published the Report of the Special Study of Securities Markets of the Securities and Exchange Commission (“Report”) in 1963. Part 4 of this Report contains an eighty page review of the NASD, and is, perhaps, the most complete study ever made of the Association. Some of the analysis is critical. We shall see more of the specifics of the Report below, but it is important to record here the Report’s general stamp of approval given the NASD and other self-regulatory bodies. The following is from SEC Chairman W. L. Cary’s Letter of Transmittal to the Congress:<sup>19</sup>

As directed by the Congress, the whole report is a broad study of the securities markets and a commentary on the adequacy of investor protection in those markets. As we indicated in our first letter of transmittal, the report demonstrates that, although serious problems do exist and additional controls and improvements are much needed, the regulatory pattern of the securities acts does not require dramatic reconstruction. In important respects this pattern has been effective, efficient, and adaptable; it has advanced and guarded investor participation in our economic growth.

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<sup>19</sup> Report, Part 4, p. v.

It is important to establish here the recognition accorded to the NASD among the regulatory bodies by the SEC, because the actual text of the Report on the NASD (Part 4, pp. 602-682) in many places may appear to render the contrary opinion. The Letter of Transmittal continues:

The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.

#### Recommendations for Changes in the NASD

The Report recommended both an increased budget and expansion of staff for the Association. These suggestions had been made earlier, before the 1963 publication of the Report, and action pursuant to them had already been taken, e.g., the 1963 NASD budget was increased 24% over fiscal 1962. The 1963 budget provided for 163 employees, an increase of 33 persons over the number employed on December 31, 1961, and 51 more than on December 31, 1960.<sup>20</sup> The basic membership fee was increased 54%, the personnel fee by 50% and underwriting fees by 25%. The 1964 NASD budget exceeded \$3 million for the first time.

Prior to January 1, 1962, nine of thirteen districts were without permanent examiners. During calendar 1962 steps were taken to make permanent assignments of examiners to all of the thirteen districts.

The registered representative examination was made more comprehensive, with the result that the rate of failure increased to 33% from about 1%. A new principals examination was formulated.<sup>21</sup>

In 1963, the SEC concluded in its Special Study that the NASD's capacity to do its job was overtaxed, and, in the opinion of the authors of that Study, the cause of this condition lay in

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<sup>20</sup> Ibid., p. 671.

<sup>21</sup> Ibid., p. 672.

the philosophy held by the Association of self-regulation where the emphasis is on “self” with a minimum reliance on a full-time paid staff. This philosophy had its effect most fully in the area of complaints and disciplinary actions against members.<sup>22</sup>

Two factors came to play here that point up the regulatory philosophy. One is that most brokers must belong to the NASD to survive economically, so almost every type of securities broker-dealer is represented--retail houses, block trading houses, third market makers, mutual fund retailers and distributors, from the largest to the smallest. The second factor is that the Association had to accept just about any broker-dealer, with few exceptions, who applied for entry. The sieve of NASD entry standards had very large holes.<sup>23</sup>

The SEC study felt that the members who serve as volunteers on the various committees and on the Board of Governors are so preoccupied with the details of disciplinary matters that little time is available for management planning of the broader questions of policy and direction.<sup>24</sup>

The solution of this problem, it is believed, will require substantial rethinking as to (1) the composition and role of the full-time staff in relation to the role of the volunteer officials, and also as to (2) the allocation of responsibilities among volunteer member participants.<sup>25</sup>

In comparison to the New York Stock Exchange, the NASD staff was small and, the Study concluded, “without any criticism of individuals making up the staff, that the NASD

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<sup>22</sup> Ibid., p. 674.

<sup>23</sup> Id.

<sup>24</sup> Id.

<sup>25</sup> Ibid., p. 675.

version is inadequate except on a theory that the staff's role should be minimal both in quantity and in responsibility, as compared to that of volunteer officials.<sup>26</sup>

As early as 1938 the New York Stock Exchange went over to a system that deemphasized the role of member committees and increased the role of the permanent staff. The American Exchange and Midwest Stock Exchange have also moved recently in the same direction.

Any recommendation to the NASD by the Study was understood to retain the role of primacy held by the Board of Governors. The staff would be understood to serve and strengthen the concept of self-government.<sup>27</sup> For the longer term, permanent hearing officers were proposed to conduct hearings and to prepare cases for the full business conduct committees in the districts. This would also tend to separate the roles of those in the investigatory phase of a case from those involved in deciding the case. Such a distinction would increase the fairness of disciplinary procedures.

The NASD By-Laws state that nominating committees "shall endeavor, as nearly as practicable, to secure appropriate and fair representation on the Board of Governors of all classes and types of firms," pursuant to Section 15A(b)(6) of the 1934 Act. Because of size, many districts can elect only one member to the Board of Governors every three years, which makes it inherently difficult to provide for a democratic representation of all classes and types of firms. Therefore, the SEC suggested providing for a limited number of governors elected at large to fulfil the statutory requirement of democratic representation.

The SEC Study also expressed the opinion that the NASD, while it had made important progress in self-regulation, had made progress not on its own initiative but at the instigation of

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<sup>26</sup> Id.

<sup>27</sup> Ibid., p. 676.

imminent action by the SEC or Congress. However, the Study reaches the important conclusion “that it (NASD) has basically proven itself in practice despite the shortcomings pointed out in the report.”<sup>28</sup>

The 1963 Special Study makes these conclusions and recommendations for the NASD:<sup>29</sup>

1. Because of certain factors peculiar to the NASD its job is made especially difficult. It has relied on ethical standards and has limited legal codification. It has limited hired staff and relied on industry volunteers. It has had to admit all qualified persons.
2. Despite many accomplishments, the Association has fallen short of its potential as a self-regulatory agency and needs to be basically modified and strengthened.
3. The functions and responsibilities of member officials and paid staff should be realigned to allow the Board of Governors to perform their role of management leadership and directors of policy.
4. The executive director should be made a president with voting rights on the Board of Governors. The staff should be increased in size and upgraded.
5. The National Business Conduct Committee should have final power of decision in disciplinary matters except in special cases. An executive committee should be formed.
6. More democratic representation should obtain on district committees and on the Board of Governors.
7. Uniformity among districts in matters of surveillance should be furthered. Staff and methods should be strengthened. Automated Data Processing should be used.

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<sup>28</sup> Ibid., p. 679.

<sup>29</sup> Id.

8. There has been a serious problem, regarding disciplinary matters, in all securities regulatory bodies and not restricted to the NASD, with respect to efficiency and speed in handling disciplinary cases. Full time hearing officers should be appointed to lighten the burden of hearings now imposed on district committees. Disciplinary matters resulting in the imposition of penalties should be publicly reported.

9. The NASD budget may be subject to future increases because of its increased role. The present fee structure may be inequitable because, while it takes into account the amount of underwriting business, it does not account for the amount of trading activity engaged in by its members.

#### The 1964 Amendments to the Securities Exchange Act of 1934

All important feature of the Securities Exchange Act of 1934 and the amendment thereto known as the Maloney Act of 1938 is the self-regulation element granted to the national securities exchanges and registered national securities associations. Only the NASD has registered under the provisions of this Act. The SEC has oversight of the self-regulation provisions of the 1934 Act.

Until the 1964 Amendments, the 1934 Act suffered from at least three major deficiencies. First, neither the SEC nor the NASD had the express authority to exercise control over membership. Second, the NASD was not required to adopt rules regarding standards of training, competence and experience of its members and their employees, and, further, it had no authority to adopt minimum standards of financial responsibility for its members. Third, membership in the NASD was not compulsory, resulting in a regulatory gap in the securities industry.<sup>30</sup>

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<sup>30</sup> Graham L. Sterling, Jr., "National Association of Securities Dealers and the Securities Acts Amendments of 1964," 20 Business Lawyer 313 (January 1965), pp. 495-497.

### Disciplinary Powers over Individuals

Prior to the Amendments, in order to proceed against an individual, it was necessary first to take disciplinary action against the firm with which the individual was registered. Given these circumstances, the SEC and NASD were reluctant to take “effective disciplinary action against an otherwise innocent firm in order to reach the conduct of the individual.”<sup>31</sup>

The Amendments give the SEC authority to discipline an individual for violation of its rules by suspending him from association with a broker-dealer firm or by suspending him from association with a member of the NASD.<sup>32</sup> Now the NASD can take action directly against an individual without having to proceed against a firm.<sup>33</sup> The Amendments require that the NASD establish rules covering persons associated with a member.<sup>34</sup> If the SEC or NASD institutes disciplinary proceedings against an individual which result in the suspension or expulsion of the individual, such action requires the NASD to refuse him entry to the Association should he apply to become a sole proprietor, or when a firm with which he is associated applies for membership.<sup>35</sup>

Previous to the Amendments, a firm could be barred or expelled from membership in the NASD because a person associated with it was subject to one of the express statutory bars, the employer not knowing, or not having reason to know, of the disability of the associated person.<sup>36</sup>

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<sup>31</sup> Ibid., p. 497.

<sup>32</sup> 1934 Act, Sections 15(b) (7) and 15A(1), (2).

<sup>33</sup> NASD By-Laws, Article XV, Section 6.

<sup>34</sup> 1934 Act, Section 15A(b) (9).

<sup>35</sup> 1934 Act, Section 15A(b) (4).

<sup>36</sup> Sterling, op. cit., p. 499.

The broker-dealer is now subject to suspension only if he knows or should have known of the statutory disqualifications. Membership will be denied or revoked only if the broker-dealer knows or should have known in the exercise of reasonable care that the person in question, if he were a broker or dealer, would be ineligible for admission to or continuance in membership.<sup>37</sup>

Other problems being faced by the 1963 Special Study<sup>38</sup> concern upgrading the securities industry and focus on assuring the good character and integrity of persons associated with members. In response to these recommendations the NASD authorized the Board of Governors to define specific and appropriate standards with respect to training, experience and any other qualifications they might consider necessary.<sup>39</sup>

While the Special Study of 1963 stated that assuring the good character and integrity of the securities industry was to be counted among the most important regulatory problems, it also acknowledged that this is the problem most difficult to resolve.<sup>40</sup> While this problem is still being grappled with by the NASD, the SEC is concentrating on problems of registration of over-the-counter securities and insider trading; and in cooperation with the NASD it is working on the problem of financial responsibility and the supervision of salesmen.<sup>41</sup>

### SECO

Most broker-dealers are registered with the NASD. There are definite economic and administrative advantages to membership. For example, an NASD member cannot give a non-

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<sup>37</sup> NASD By-Laws, Article I, Section 2(a) (D) (NASD Manual, p. 1045).

<sup>38</sup> Report, op. cit., Part 1, ch. II, p. 151. See also: Report of Senate Committee on Banking and Currency to Accompany S. 1642, S. Sep. No. 379, 88th Congress, 1st Session (1963).

<sup>39</sup> NASD By-Laws, Article I, Section 2(d).

<sup>40</sup> Report, op. cit., Part 1, ch. II, p. 161.

<sup>41</sup> Sterling, op. cit., p. 504.

member commissions or deal with him except as he would with any public customer. A non-NASD member may not participate in an underwriting managed by NASD members.<sup>42</sup> Further, various states often require those distributing shares of securities, such as no-load mutual funds, to register as broker-dealers in their states. It is administratively advantageous for such broker-dealers to be NASD members in these cases.

It is possible, however, for broker-dealers to conduct a securities business under registration to the Securities and Exchange Commission Only, hence the acronym “SECO”. The SECO program resulted from the 1964 Amendments to the Exchange Act, and provides for direct regulation by the SEC under Section 15(b) (8), (9) and (10).<sup>43</sup> Some firms, notably mutual fund dealers, objected to compulsory membership in the NASD on the grounds that they were being subjected to regulation by the very firms they considered to be their competitors.

Provisions of the program require that associated persons qualify by means of an examination comparable to NASD examinations. Rule 15b9-2 under the Act provides for annual assessments to be paid to defray the costs of regulation.<sup>44</sup> In 1973 the NASD administered 2,567 qualification examinations for SECO.<sup>45</sup> The number of firms in SECO registration as opposed to NASD registration has declined since 1969 from a total of 455 to 276 in mid 1973.

SECO broker-dealers engage in a variety of securities businesses. The principal type of business is the general securities business.<sup>46</sup> In 1973, 24% were in general securities, 9% were

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<sup>42</sup> SEC Annual Report 1970, p. 54.

<sup>43</sup> Sterling, op. cit., p. 504.

<sup>44</sup> SEC Annual Report 1970, pp. 87-88.

<sup>45</sup> SEC Annual Report 1973, p. 54.

<sup>46</sup> Ibid., p. 146.

mutual fund underwriters and distributors, 7% were selling variable annuities, 16% were exchange members engaged in either floor activities or exchange commission business.

### Self-Regulation vs. Self-Interest

In June 1973 a symposium was held in Washington to commemorate the 35th anniversary of the enactment of the Maloney Amendment. A panel discussion was held to enable past executive officers to view NASD progress. Mr. Robert M. Gardiner, who served as President Pro-tem of the NASD for several months in 1967, raised the question of self-interest versus public interest in the Association's goals. Ever since 1934, beginning with the NASD's predecessor organization, the Investment Bankers Code Committee, the aim of the over-the-counter industry trade group had been "To observe and use their best efforts to maintain high standards of commercial honor in the investment banking business, and to promote just and equitable principles of trade and business." Mr. Gardiner quotes a witness to the success of the NASD who wrote (as cited in the 1967 NASD Annual Report): "Nowhere in my long experience in the securities business have I witnessed the dedication and complete lack of self-interest which are displayed by the men who direct the activities of your Association."<sup>47</sup> However, having been the President Pro-tem for a short period of time, Gardiner was in a position to know that the Association was not absolutely immune from criticism on this score. The NASD Annual Report for 1966 had raised questions in Congress and in the SEC as to whether this Report "was consonant with the purposes of a national securities association as contemplated by the Statute."<sup>48</sup>

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<sup>47</sup> 1967 NASD Annual Report, p. 3.

<sup>48</sup> 35th Anniversary Proceedings, p. 44.

The President's Report in this 1966 Annual Report (Robert W. Haack was NASD President from 1964 to 1967 and was New York Stock Exchange President from 1967 to 1972) treated subjects such as the Booz, Allen & Hamilton Impact Study (the impact of published inter-dealer quotations on markets and profits) and the change to an all inter-dealer quotations system, over-the-counter profits tied to SEC mutual fund proposals, etc.

Criticism of that 1966 Report came from the Chairman of the House Committee responsible for the national securities industry, Harley Staggers. Congressman Staggers wrote to Commissioner Manuel Cohen of the SEC. In reply to Staggers, Cohen wrote:

The tenor of the NASD report, however, is such as to place primary emphasis upon the economic interests of certain members rather than upon the self-regulatory responsibilities vested in the NASD by the Maloney Act. For example, in describing the Association's activities for the year, five pages are devoted to steps taken to protect the financial interests of members before it devotes a paragraph to each of the major self-regulatory functions.<sup>49</sup>

In 1966, as an outgrowth of the 1963 SEC Special Study, the SEC had made certain proposals to change existing regulations concerning disclosure of profits in over-the-counter broker-dealer firms, abolition of "riskless" transactions, and revealing the inside market when sales of securities were made from a dealer's inventory. Regarding mutual fund transactions, the SEC proposed significant reductions in sales charges and would bar reciprocal business arrangements whereby mutual fund managers would direct portfolio transactions to stock firms in exchange for the stock firms' efforts in selling the fund's shares. President Haack felt that the SEC 1963 report was using aged data assembled before 1961, reflecting unusual growth in the over-the-counter industry, which would no longer support the conclusions drawn in 1966.<sup>50</sup>

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<sup>49</sup> Ibid., p. 45.

<sup>50</sup> 1966 NASD Annual Report, p. 5.

Mr. Gardiner further cites a 1967 statement of Congressman Moss in connection with the then current tendencies of the NASD:

Certainly the historical concept of the Association of this great experiment of members of the industry banding together for the purpose of self-regulation in order to protect investor and the public interest is well known. More recently, however, there is some doubt whether the activities of the Association are so oriented.<sup>51</sup>

This exchange, between Robert Haack representing the NASD in 1966-67 and members of Congress and the SEC, emphasizes the present tendency to drop the phrase “self-regulation” in favor of the concept “cooperative regulation”.<sup>52</sup> Private bodies such as the exchanges and NASD are more than trade associations in that their rules are vested with governmental powers to be exercised in the public interest and for the protection of investors.<sup>53</sup> Those at the helm must avoid both the Scylla of pure self-interest exemplified by the mere trade association, and the Charybdis of pure regulatory power exemplified by a governmental agency. The NASD must serve both the public interest and the interests of the membership. In the instance cited above, Congress and the SEC were voicing their opinion that the helmsman was veering dangerously toward the rock of Scylla and self-interest.

The following statement by Mr. Justice William O. Douglas delineates the most important advantage of self-regulation in establishing “ethical standards beyond those any law can establish”:

Self-regulation . . . can be persuasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription, that leaves untouched large areas of conduct and activity; some of it susceptible of

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<sup>51</sup> 35th Anniversary Proceedings, p. 45.

<sup>52</sup> Securities Industry Study (House, 1972), pp. 79 ff.

<sup>53</sup> Ibid., p. 83.

government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government and self-government alone, can effectively reach.<sup>54</sup>

### The Original Idea of Self-Regulation and the Growth of Self-Regulatory Staffs

In 1934 and 1938, when the Securities Exchange Act and the Maloney Act were passed, self-regulation meant collective regulation by business organizations. It meant that the business of self-regulation was carried out almost exclusively by volunteer participation of members.<sup>55</sup> It was the direct involvement of the members themselves in self-regulation that gave it credibility. However, when members were faced with the task of formulating standards and policing compliance with these standards among themselves, it appeared that self-regulation could be performed only at the expense of their business operations. Thus grew the need for staff, both on the exchanges and in the NASD. The membership in self-regulatory bodies retains control, but the role of the administrative staff has grown in importance. “The need for public, official oversight may be modified,” in the opinion of the 1963 SEC Special Study, “but surely is not lessened, by this intervention of private regulatory staffs made inevitable by inherent practical limitations on the workability of ‘pure’ self-regulation.”<sup>56</sup> In the opinion of the House Study of 1972, “Both at the inception of the NASD and since, growth of staff there and at the New York Stock Exchange has been resisted by members, urged by the Commission, and recognized by all to be of major consequence.”<sup>57</sup>

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<sup>54</sup> Securities Industry Study (Senate, 1973), p. 149.

<sup>55</sup> Securities Industry Study (House, 1972), p. 84.

<sup>56</sup> Report, Part 4, p. 696.

<sup>57</sup> Securities Industry Study (House, 1972), p. 85.

Instead of a two-tier structure of the SEC and members collectively regulating themselves, there is a three-tier structure of the SEC, the NASD or exchange board or staff, and the membership. Self-regulation thus becomes a misnomer and cooperative regulation becomes a more accurate description of the situation as it exists.

### The NASD and Accounting

In gauging the health of broker-dealers, the NASD staff must be reasonably proficient in accounting in order to analyze the members' financial reports. The concern of regulatory bodies has always been that the customer get a "fair shake." In the early 1940's this concern was concentrated on markups. In the late 1960's concern was focused on the viability of the broker-dealer. This concern was expressed through the creation in 1970 of the Securities Investor Protection Corporation (SIPC) to provide insurance for customer accounts in the event the firm should go bankrupt or be otherwise unable to make good customer accounts.

Concurrent with concern for financial liability has been the attempt to standardize accounting procedures.<sup>58</sup> All firms follow "generally accepted accounting principles." It is felt that this is not enough, however, because auditing firms have reached different accounting results relying on the same principles. "Accounting procedures, as opposed to accounting principles, prescribe in a definitive manner how transactions and other events should be recorded, classified, summarized and presented and are the means for implementing these principles."<sup>59</sup> Through uniformity of accounting procedures it is hoped that regulatory bodies such as the NASD can better keep their finger on the pulse of the industry and predict when a firm goes into the danger zone of fiscal ill health.

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<sup>58</sup> Ibid., p. 49.

<sup>59</sup> Id.

Regulatory bodies are responsible to a degree for the lack of standardized accounting procedures. For example, NASD member firms are required to submit the following reports:

1. Form X-17A-5, annual report of assets and liabilities, to the SEC.
2. Form X-17A-10, annual report of income and expenses, to the SEC and NASD.
3. Form Q, quarterly financial report, to the NASD.
4. Form M, monthly financial report, to the NASD.

If the firm belongs to any combination of NASD, AMEX and NYSE, it reports to the regulatory authority designated by the SEC or SIPC on the Joint Regulatory Report (JRR). The NASD is working with the SEC and the exchanges to simplify reporting requirements.

Regarding broker-dealer disclosure to customers, amendments to SEC Rule 17a-5 made in 1971 and 1972 require that quarterly and annual disclosures of the firm's financial condition be made.

#### Securities Firms Audits

The present audits of NASD firms are based on the requirements of SEC Rule 17a-5 and are reported on Form X-17A-5. Independent auditing procedures of securities firms where customer securities counts and verifications are included are more extensive than those applicable to audits of other business enterprises, at least of the simpler variety. The House Study of 1972 found that independent audits in the securities field were generally adequate.<sup>60</sup>

To insure the independence of auditors it is now required that any broker-dealer who changes auditors notify the SEC, disclosing the reason for the change. He must also state whether the change is due to a disagreement between the firm and the auditor. Since the broker-dealer pays the auditor's fee and engages him, in the first place, it is important to insure

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<sup>60</sup> Ibid., p. 54.

independence as much as possible. The necessary disclosure of a disagreement with the independent auditor renders it less likely that his client will summarily dismiss him, and will remove the fear of “standing up” to his client if he feels he has to.

#### Regulatory Examinations of Broker-Dealers

Since there is an apparent lack of uniformity between examinations conducted by different cooperative regulatory bodies, the Subcommittee (of the House of Representatives) recommends that, insofar as possible, one agency be assigned the responsibility for conducting examinations of broker-dealers. A logical choice would be the National Association of Securities Dealers, which has the vast majority of broker-dealers among its membership.<sup>61</sup>

A great many, if not most, exchange broker-dealer firms are also registered with the NASD. The NASD is geared to regulation of customer-oriented operations and has the personnel and expertise necessary to perform in the role suggested by the Senate Subcommittee. The future of this suggestion, however, depends on the structure to be assumed by the central market.

#### New and Improved NASD Regulatory Procedures

Elimination of redundant reporting requirements has been a principal objective over the past several years. Some progress has been made. The NASD Annual Assessment Report was merged into the Annual Report (Form 17A-10). Quarterly financial reporting to the NASD by members who are furnishing quarterly data to the New York and American Stock Exchanges was eliminated. Information for these firms is now forwarded to us by the exchanges. This past year the NASD and other regulatory bodies, including the state securities administrators, began work on a single uniform registration form for individuals to be accepted by all regulatory organizations. This development offers the prospects of substantial savings for many members...<sup>62</sup>

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<sup>61</sup> Ibid., p. 56.

<sup>62</sup> Gordon S. Macklin, 1973 NASD Annual Report, p. 3.

### Founding of SIPC

The Securities Investor Protection Corporation (“SIPC”) was founded in 1970 by the SIPC Act to provide some insurance of investors’ cash and securities left in the hands of broker-dealers who must liquidate because of financial difficulties. The growing volume and the consequent broker-dealer operational problems stemming therefrom in the late 1960’s precipitated this action. It was at the advice of both the SEC and of the securities industry that SIPC was founded. Both realized that the self-regulatory bodies’ efforts might be insufficient to prevent injury to the securities business and to the investing public. They, therefore, recommended to Congress that SIPC be founded to provide protection to public investors. The result was the SIPC Act providing protection up to \$20,000 for customer cash, and a total of \$50,000 in cash and securities.<sup>63</sup>

The NASD handles relations between its member firms and SIPC, including collection of assessments, and reports to SIPC firms whose customers are in need of protection or are in imminent danger of needing such aid.

### NASDAQ

On February 8, 1971 the National Association of Securities Dealers Automated Quotation System (“NASDAQ”) became operative. This is a system based on a computerized network of television-type displays (“CRT”) in broker-dealer offices carrying bid and asked quotations on some 3,000 securities issues. The number of CRT’s is over 25,000 in nearly 1,000 brokerage offices. Senator Harrison Williams, Jr. said that NASDAQ “has changed the communication system in the over-the-counter market from a cumbersome, obsolete collection of multi-colored

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<sup>63</sup> Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the SEC (United States Government Printing Office, Washington, D. C., 1971), p. 23.

‘sheets’ into a sophisticated real-time system capable of providing instantaneous market information.”<sup>64</sup>

The securities analyst who uncovered the Equity Funding case of 1973, Raymond L. Dirks, has the following to say about NASDAQ:

There is an infinitely more appropriate market (than the auction market of the floor of the NYSE), and the technology to product it. It’s called a dealer market. Instead of one specialist standing in one place making a market, there are ten, 20 or more market makers willing to buy and sell through the facilities of a computerized visual-display system that functions on a national basis. Whereas the auction market is a monopolistic system, the dealer market encompasses everyone. A system called NASDAQ tells which dealers anywhere in the country are willing to buy or sell a stock. A seller need only push a button to find the highest bidder for his shares.<sup>65</sup>

This is a somewhat simplistic assessment of the controversy between the NYSE auction market and the over-the-counter dealer market. However, it does give the reader some of the basic facts of the controversy. No mention is made in the argument, however, of the requirement that the NYSE specialist function under certain circumstances in the public interest and in the interest of an orderly market. Dirks and Gross continue:

If many specialists were permitted to make a market in a stock, the price would invariably be the most advantageous possible to the customer. So would the cost of doing business. Competition would produce smaller price spreads and lower commissions. But as long as the stocks of the most important companies in the country can be traded only on the New York Stock Exchange, NASDAQ cannot fully function.<sup>66</sup>

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<sup>64</sup> 1971 NASD Annual Report, p. 9.

<sup>65</sup> Raymond L. Dirks and Leonard Gross, The Great Wall Street Scandal (McGraw-Hill, New York, 1974), pp. 251-252.

<sup>66</sup> Ibid., p. 252.

At the end of 1973, NASDAQ carried quotations on 2,932 securities, down from a peak of 3,500. It began in February 1971 to carry the bid and asked quotations of all member firms. More than any single instrument, it has been responsible for upgrading the over-the-counter securities market. The quotations of every dealer in every stock can be known immediately, at the press of a button. Initial studies on the statistics of NASDAQ shortly after it opened in 1971 revealed unsuspected data on over-the-counter activity. For instance, NASDAQ volume of shares traded is greater than all the exchanges combined with the exception of the NYSE. In December 1971 volume was on average over 8 million shares traded daily. “The Association continues to view NASDAQ as the foundation on which the industry can build to maintain the over-the-counter market as a fair and orderly marketplace as well as a major profit center.”<sup>67</sup>

There are some areas where obstacles to over-the-counter trading on NASDAQ exist and where NASD is working to open the market to free trading. One is the Federal Reserve Margin List. Here it is hoped to expand the number of over-the-counter issues eligible for margin. Second is the exemption of over-the-counter registration under state securities laws (“blue sky” exemption). Many states grant blanket exemptions to exchange listed securities while denying such exemption to over-the-counter issues. Third is the prohibition against investing in over-the-counter issues by trustees and administrators of state pension funds under state law. A fourth obstacle is the prohibition by foreign nations’ laws against their citizens purchasing of over-the-counter securities.<sup>68</sup>

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<sup>67</sup> 1973 NASD Annual Report, p. 10.

<sup>68</sup> Id.

### NCC: What It Is

The National Clearing Corporation was created in 1969 as a subsidiary of the NASD to develop a nationwide “continuous net clearing system” for the over-the-counter market. There are clearing centers in ten major U. S. cities serving 300 member broker-dealer firms. “Under a continuous net system, all settlement, receipts and deliveries of securities are made directly with the clearing corporation rather than with individual brokers. Members are sent a daily statement indicating money and securities either owed to the clearing corporation or credited to the firm. Dividend accounting and processing of transfer instructions are provided; and all open securities positions are marked to the market daily.”<sup>69</sup>

### NCC: Immobilization of the Stock Certificate

In November 1973 the NCC added to its services the Free Account Net Settlement (FANS) System. The free position stops the flow of certificates by allowing NCC members to leave their securities in free positions at NCC, with deliveries being made by bookkeeping entry. “NCC members are no longer required to continually receive and deliver certificates to complete transactions with NCC.”<sup>70</sup>

### The Third Market

The third market is the over-the-counter sale of common stocks listed on the NYSE. The SEC has required reports of third market statistics since 1965. Institutional sales are often transacted in the third market. Third market sales have increased both in volume and in dollar value each year since 1965, the increase keeping pace with NYSE volume growth in every year but one. Third market share volume has grown from 2.7% of the 1965 NYSE volume to 7.3% in

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<sup>69</sup> NASD Press Release, NSD 3774, July 31, 1974.

<sup>70</sup> 1973 NASD Annual Report, p. 16.

1972. This 7.3% in 1972 represents 327 million shares. Dollar volume grew from 3.4% in 1965 to 8.5% in 1972, the latter representing a value of over \$13 billion.<sup>71</sup> Needless to say, the NASD has represented its members as being in favor of continuing the third market business before Congress.

The third market removes NYSE issues from the monopoly of the specialist and places them in the competitive dealer market of the over-the-counter area. Many times investors can purchase at better prices in the third market. The NYSE has been unmitigatingly opposed to the third market as a threat to the profitability of its members. The third market issue has been an important factor in negotiations between Congress and the industry over the future central market. Probably the SEC will be empowered to start or stop the third market in light of the common interests of all concerned, investors and the industry.

### Conclusion

To conclude this consideration of recent developments in the Association's history is this digest of an address by Frank J. Wilson, Senior Vice President of the NASD. The occasion was the celebration of the 35th Anniversary of the Maloney Amendment.<sup>72</sup>

The purpose of the Maloney Act "is to provide a mechanism for broker-dealers to regulate their own activities in the over-the-counter securities market...The Association, first and foremost, is and must be a regulatory body. That's the charge Congress gave it." There has been an evolution in the Association's approach to regulation. Today, the NASD is more concerned with "preventive medicine" than with finding out about violations after the fact and imposing disciplinary sanctions. The NASD is trying to look into the future by way of a program of continual surveillance to forecast the future of a broker-dealer by analysis of current trends in its operation, and take action accordingly, such as placing the firm under certain restrictions in the way it does business. "If liquidation appears the better course for a given firm" such a procedure is

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<sup>71</sup> SEC Annual Report, 1973, p. 156.

<sup>72</sup> Pp. 8-9.

recommended and the NASD assists in the liquidation. From 1968 to 1973, in five years, the examining staff has expanded 400%. As of 1958 the NASD had a total of 26 professional staff in the field. In 1973 there were 300 persons in the field plus 100 in the executive office engaged in regulatory activities.

These remarks call to mind the recommendations made by the SEC Study of 1963. The NASD's new philosophy of self-regulation is "preventive medicine". The evolution begun ten years previously has become a part of everyday life for the Association.

## CHAPTER IV

### FUTURE GOALS

#### The Central Market: The 1973 Senate Study

The objective of a central market system is to tie together all of the market facilities in which a particular stock is traded so that all potential buyers and sellers, and their brokers, can be instantly aware of all transactions in, and all quotations for, that security, and thus obtain the best price in the best market.<sup>73</sup>

One of the reasons a central market had become a real possibility in 1973 is that 17% of all issues traded on the NYSE and 30% of trading in the most active issues take place on regional exchanges in various parts of the country and over-the-counter or in the third market.<sup>74</sup>

The SEC has called for the development of an open access central market system in which any qualified dealer can make a market in a stock. For example, many over-the-counter broker-dealers at present make competitive markets in the same stock. Their bid and asked quotations, prices at which they stand ready to buy (bid) or sell (asked) a round lot (100 shares) are flashed on the NASDAQ CRT display on a nation-wide basis when a broker keys in the symbol of the stock. The SEC considers this dealer competition healthy and desirable. The

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<sup>73</sup> Securities Industry Study, Report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate (United States Government Printing Office, Washington, D. C., 1973), 93rd Congress, 1st Session, pp. 9-1C.

<sup>74</sup> Ibid., p. 10.

NYSE has been urging a central exchange system, in contrast, where all other market makers except the exchange specialists would be excluded. There are pros and cons to both systems. However, the Senate Subcommittee favors the SEC approach as providing the least market distortion and the best execution for customers. The exchanges can exercise vigilant surveillance over their specialists minute by minute, it is true. This is the best of the exchange system. At worst, the specialist can take advantage of the monopoly he enjoys. The dealer market at its best can engage in honest, open competition and a broker can “shop” for his customer among the dealers. At its worst dealers can be in collusion behind the scenes and move the price according to a prearranged pattern, all at the expense of the unwitting customer.

#### The NASD and the Central Market Controversy

The technology is available for the central market. In fact, the equipment and network are already in use for two or three existing systems. The principal barriers are (1) the existence of rules preventing brokers from taking their customers’ orders to the market in which the best price is available, and (2) a united, central communications system for reporting transactions and quotations.<sup>75</sup> Best price availability has already been an important issue. How many mutual fund managers have not faced lawsuits from shareholders because the fund failed to go to the “third market” where listed stocks could be bought and sold at better advantage than on the exchanges? Some funds have set up subsidiary broker-dealerships having membership in the NASD partly for this very purpose.

The NASD and the regional exchanges are in disagreement with the NYSE and the AMEX as to who should run the system, and who should have access to a central system and on what terms.

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<sup>75</sup> Id.

### Allocation of Jurisdiction among Self-Regulatory Agencies

The current status of self-regulatory responsibility has two drawbacks: (1) In the case of firms belonging to more than one agency, there is some confusion as to which agency is responsible. This leads to duplication of effort which is wasteful and expensive. (2) The regulatory standards of the different agencies differ both in substance and in enforcement. “This may lead to a ‘Gresham’s Law’ of regulation, in which marginal firms become members of the self-regulatory organization which has the least rigorous standards.”<sup>76</sup>

The Senate Study of 1973 states that although the SEC in its 1972 “Statement of Policy on the Future Structure of the Securities Markets” stated that it was not yet necessary to design a self-regulatory structure for the future, the Senate Subcommittee does feel “this is the appropriate time to begin planning the regulatory framework which will guide the development of the self-regulatory system.”<sup>77</sup> The Senate Study says this about the NASD in particular:

For the long term, the Subcommittee envisions the need for a major rearrangement of the regulatory structure of the securities industry to meet the needs of the new central market system. The jurisdiction of a national securities association should be extended to cover all of the activities of its members in dealing with public customers. This would include jurisdiction over selling practices, financial responsibility requirements, competence of personnel, and similar matters. Under this provision, the regulatory activities of the NASD... would encompass many of the present regulatory activities of the NYSE and other exchanges over retail activities of their members. This ‘expanded’ NASD would have direct responsibility, subject to SEC oversight, for enforcing SEC rules and its own rules and ethical standards on the retail activities of all firms engaged in doing a securities business with the general public. This organization, however, would not have a direct hand in operating or controlling any central market facility.<sup>78</sup>

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<sup>76</sup> Ibid., pp. 164-165.

<sup>77</sup> Ibid., p. 168.

<sup>78</sup> Ibid., pp. 168-169.

### National Securities Market System Act of 1974: S. 2519

With regard to the previous paragraphs on allocation of jurisdiction among self-regulatory agencies, the Senate Committee responsible for S. 2519 describes the same dissatisfaction with the present scheme of self-regulation, but does not incorporate into S. 2519 the scheme for making the NASD responsible for all retail activities of the broker-dealers<sup>79</sup> to be found in the 1973 Senate Study.

### The Proposed Stuckey Amendment to the '34 Act

Representative W. S. (Bill) Stuckey, Jr. of Georgia, a member of Congressman Moss's Subcommittee on Commerce and Finance, on May 8, 1974 introduced a Bill in the House of Representatives (H.R. 14685) to amend the Securities Exchange Act of 1934. The Subcommittee had a year earlier introduced H.R. 5050, but by July of 1973 there seemed but small chance of its passage in Congress.

The novelty of H.R. 14685 is that it proposes to set up a "National Market Board Authority" ('Authority') which in turn will create a "National Market Board" ('Board') to regulate a "National Market System" ('System') for the trading of securities. This amendment would become Section 15B of the '34 Act. (Section 15A is the Maloney Act.)

The Authority is to be made up of persons from varied backgrounds, not just from the securities industry. This proposal is reminiscent of William McChesney Martin's proposals to provide for electing persons of varied background to the Board of the NYSE. Among the fields to be represented on the Authority are the exchange and the NASD, the securities industry, users of the system, public investors, members of the SEC and others. The Authority is to draw up a constitution and rules and is to propose a Board. The Rules are to be promulgated by the SEC.

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<sup>79</sup> Report of the Committee on Banking, Housing and Urban Affairs, United States Senate, to accompany S. 2519, p. 29.

In turn, the Board would regulate and govern the System subject to SEC oversight. The Board's authority would encompass the following areas:

1. Eligibility of securities to be traded in the System.
2. Running a composite quotation system.
3. Rulemaking power necessary to insure fair and equitable treatment of everyone involved in the System.
4. Membership criteria for the System but excluding banks, insurance companies, investment companies (mutual funds) and their subsidiaries and affiliates.
5. Minimum commission rates.

The Amendment proceeds as follows:

When the Board is elected, it will

1. Assume the "powers, privileges, rights, and obligations" of the national securities exchanges and the NASD.
2. Leave to the exchanges and the NASD all self-regulatory functions which have not been assumed by the Board.
3. Be subject to the SEC regulatory authority in the same way as the exchanges and the NASD.

These proposals are far-reaching, and make a unity of the existing patchwork quilt of the existing securities markets. The present conglomeration grew up historically during the past 150 years. It is centered in New York, and especially in the auction market on the New York Stock Exchange. However, with the growth of operational efficiency and ease of communications made possible by computer and other technological advances, concentration in a physical location like the floor of the NYSE is no longer necessary. The last thirty years since

World War II have seen a dramatic shift in population density of the United States away from the northeast. Advances in technology make possible, to some extent, a parallel shift in the securities industry away from New York. The dealer market of the NASD, combined with NASDAQ and the NCC, has already allowed for such a shift. The present proposal would combine to some degree all of the local markets into one large central system, depending on the extent to which the Board allows broker-dealers in the system to utilize all of the facilities in the system and to trade all securities issues admitted to the system. Presently, national exchange member firms are generally restricted to the handling of listed stocks only, with some exceptions. Over-the-counter broker-dealers can handle both listed and unlisted stocks almost without exception.

For the time being, mid 1974, the Stuckey Amendment is one more “iron in the fire”. No one knows yet if his proposal has a future, and one can only follow the various compromises and new proposals emerging from the Senate and House and SEC to discern an indication of the future direction the central market will take.

#### Role of the SEC in the Future Central Market

The chain of events, such as back-office inability to keep up with securities sales in the late sixties, loss and theft of certificates, failure of firms unable to maintain their customer records properly, loss of time suffered in transfer bank inefficiency, led to the passage of the SIPC Act of 1970 for customer protection. One of the provisions of this Act was that the SEC should prepare the Study of Unsafe and Unsound Practices of Brokers and Dealers.<sup>80</sup> This Study foresaw the need of a modernized, nationwide system for effecting securities transactions. Following are some of the goals the SEC set for itself and for the industry as a whole:

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<sup>80</sup> Published by the United States Government Printing Office, Washington, D. C., 1971 as House Document 92-231.

1. The Commission's authority which now covers clearance, settlement and record-keeping of securities transactions should be extended to depository and transfer functions as well.<sup>81</sup>

2. The SEC desires plenary authority with respect to the rules of self-regulatory bodies. "The Commission has no power to prevent the adoption of a particular rule by an exchange, nor to abrogate it once it has been adopted.... With respect to NASD rules, the Commission has broad powers to block a rule from being put into effect and to abrogate an existing rule, but its power to alter or supplement rules is very limited."<sup>82</sup>

3. The Commission cannot directly enforce the rules of the self-regulatory organizations against their members. It seeks this authority from Congress.<sup>83</sup>

4. The SEC seeks the right to review all disciplinary proceedings of a self-regulatory body, i.e., the exchanges and the NASD, on appeal or on its own motion, and desires that such right to review include the power to affirm, disaffirm or modify in any way deemed to be in the public interest, the findings and penalties imposed by the self-regulatory body.<sup>84</sup>

### Conclusion

The following statement by the Senate Committee responsible for creating the legislation for the future central market sums up the case very well:

The securities markets of the United States are indispensable to the growth and health of this country's and the world's economy. In order to raise the enormous sums of investment capital that will be needed...these markets must continue to operate fairly and efficiently...the securities

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<sup>81</sup> Ibid., p. 1.

<sup>82</sup> Ibid., p. 6.

<sup>83</sup> Ibid., pp. 6-7.

<sup>84</sup> Ibid., p. 7.

markets are due to be tested as never before. Unless these markets adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the Nation will suffer.

The rapid attainment of a national market system...is important, therefore, not simply to provide greater investor protection and bolster sagging investor confidence, but also to assure that the country maintains a strong, effective and efficient capital raising and capital allocating system in the years ahead.<sup>85</sup>

The 1973 NASD Board of Governors Chairman, J. Logan Burke, Jr., had this to say of the NASD efforts toward creation of the central market system:

Quite naturally, the central theme of discussion during the three years of my term on the Association's Board of Governors has dealt with the future of the over-the-counter market and its relationship to the evolving central market system. The Association has worked closely with the government, various self-regulatory organizations and the financial community in general to assist in the creation of the most efficient securities market possible. The proposed composite tape; new issue-related rules in areas of due diligence, suitability and marketing; a uniform national clearing system; uniform capital rules; and registered representative training and examination are only a few examples of our direct and in depth involvement...made possible because of the contribution of hundreds of individual committeemen from the industry and the assistance of a truly capable staff.<sup>86</sup>

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<sup>85</sup> Senate Report on S. 2519, *op. cit.*, p. 3.

<sup>86</sup> 1973 NASD Annual Report, p. 2.

## CHAPTER V

### SUMMARY, FINDINGS AND CONCLUSION

#### Summary

The NASD is the Association through which the over-the-counter securities markets are promoted and regulated, and from its “pre-history” under the NRA, the federal government has promoted this organization. It can really be said that the Association is in some ways the offspring of federal statute. If the SEC had to take over the Association lock, stock and barrel, the costs to the general taxpayer would far exceed the current annual budget of the Association. Over 300 industry executives donate their time to the NASD. It would be difficult to put a price tag on replacement cost for their contribution.

The NASD is a non-profit group. Its reason for being is above all to regulate. And since regulation of the securities industry is of interest primarily to Congress and the SEC, the best sources of information are the reports written by these two bodies. The Association has created NASDAQ and NCC. These are potential profit centers. They have created a great deal of interest in the news media, and more sources of information exist concerning them, NASDAQ especially, than about the progress of legislation and rulemaking for the NASD.

The appeal of a work such as this will be primarily to those who are interested in brokerage compliance, legal counsel to over-the-counter firms, public auditors and SEC and NASD staff.

#### Limitations of this Study

Limitations were encountered in this study by the unavailability of private unpublished NASD material; the scattered nature of the published sources, and the general lack of secondary sources, such as general histories of the Association; and the complex nature of the laws and rules. It would take years of study to become proficient with much of the material provided in the NASD Manual alone.

#### Suggestions for Further Study

Self-Regulation. The NASD has been praised by both the scholarly world and by Congress, as was seen in previous chapters, for its work on behalf of investors. The reason the federal government encouraged a self-regulatory association of investment bankers and over-the-counter broker-dealers was that the public had lost confidence and was reluctant to invest its savings. The 1929 crash was a trauma not easily healed. The success of the NASD may be seen by the relatively healthy state of the investment banking business today.

If self-regulation will work in the securities industry, when vested with government authority, is it unrealistic to suggest an NASD type of association for the oil industry, which underwent a crisis of public confidence in the winter of 1973-1973? Or the meat packing industry? Or the dairy, grain or auto industry? Of course, the NASD has its federal watchdog in the SEC; these other industries might also have their federally appointed watchdogs.

Securities Issuers. The area of concern in this work has been the regulation of securities transactions. The NASD, Congress and the SEC feel strongly that healthy securities markets

make for increased investor confidence. This is, in some ways, to put the cart before the horse. True, no investor will entrust his savings to a broker or securities market he cannot trust. But, on the other hand, given an efficient securities market, lack of aggressive securities issues will tend to make the markets very sluggish. The success of corporate issuers of securities as shown in healthy earnings, promising research and development and a strong national economy will do more for the securities markets than an efficient market. It is up to Congress to promote the economic opportunity for successful issuers as well as to promote efficient markets for the issuers' securities.

The point here is that research should be done on the relation between securities market strength and the success of the issues which are traded on that market. To illustrate the point, consider if the best NYSE issues were traded on NASDAQ by the over-the-counter dealer market. There is no question that NASDAQ would be a very healthy and strong market.

Business Ethics. A study could well be made of the economics of business ethics. It is crass to pursue ethical conduct for economic gain, and perhaps it would be more apt to suggest a study on the cost of unethical business conduct than on the profit of ethical conduct. The NASD is founded to promote high standards of commercial honor and to promote among members observance of Federal and State securities laws. From all evidence, the members and staff take seriously this goal of their work. The rules of the NASD are found on United States law which, in turn, is founded on the Constitution. The ethical and humane spirit of our laws as carried out in business and in self-regulatory bodies could well be the subject of a study.

## Conclusion

The Association has proven itself worthy of the confidence bestowed on it by its founders in the 1930's. Especially in the last ten years it has taken the initiative of self-regulation. It has used modern technology. It has built up its staff. Its activity is not limited to critical situations requiring emergency measures, but, in cooperation with the Commission and other regulatory bodies, it is trying to plan ahead to know where it is going.

“The History of the NASD” remains to be written. It is hoped that this work will provide some measure of help to the author.

## APPENDIX A: CHRONOLOGY OF NASD HISTORY

1933

Securities Act of 1933.

NIRA

November NRA Code of Fair Competition for Investment Bankers approved by President Franklin D. Roosevelt.

1934

Securities Exchange Act of 1934.

Investment Bankers Code of Fair Competition under NIRA defined standard of the investment banker as: “To observe and use his best efforts to maintain high standards of commercial honor in the investment banking business, and to promote just and equitable principles of trade and business.”

March Amendment to Code of Fair Competition incorporating Rules of Fair Practice approved by President Franklin D. Roosevelt.

1935

Schechter Case – NRA declared unconstitutional.

Spring Investment Bankers Conference Committee set up after demise of NRA, an informal voluntary organization concerned with Code similar to NRA code, and set of rules for business ethics rather than law.

1936

Sept. 3. Formation of Investment Bankers Conference, Inc. organized as non-profit investment corporation under laws of Delaware. IBC has 1,617 registered members.

1937

SEC recommended to Congress adoption of legislation to provide for an organization to regulate the over-the-counter market in public interest.

1938

June 25 Maloney Act passed by Congress (Section 15A of Securities Exchange Act of 1934).

## Appendix A: Chronology of NASD History

### 1939

- March 20 SEC and IBC submitted plans leading to formation of a national securities association under provisions of Maloney Act to 1600 security dealers, members of Conference.
- July 13 SEC announced rules for registration of a national securities association.
- July 15 First 22 sections of Rules of Fair Practice and Code of Procedure adopted.
- July 18 Amendment to certificate of incorporation approved changing name from Investment Bankers Conference, Inc. to National Association of Securities Dealers, Inc.
- July 20 Application filed for registration as a national securities association under Section 15A of '34 Act as amended.
- August 1 Full hearing held before full Commission.
- August 7 SEC issued order granting registration of NASD as a national securities association.

### 1940

NASD News begins publication.

- August Membership in NASD about 3,000.

### 1941

Attempts to enact minimum net capital requirement overruled by SEC.

- August 1 Uniform Practice Code adopted.

- November Association successful in challenging unlisted trading of over-the-counter securities on the New York Curb Exchange.

### 1943

Nationwide questionnaire examination program begun.

A member is expelled for filing false information with the Association, thereby establishing an important precedent.

5% markup policy is adopted.

## Appendix A: Chronology of NASD History

### 1943

June 27 amendments approved by membership to the By-Laws, Rules of Fair Practice and Code of Procedure. These included a proposed minimum net capital requirement of \$5,000/\$2,500. SEC disapproved this and adopted capital ratio rule of 20 to 1.

### 1945

SEC rules against NASD in Public Service of Indiana case concerning maintenance of price agreements in an underwriting.

Authorization granted by Federal Reserve Board empowering NASD to grant Regulation T time extensions.

Registration required of salesmen, traders, officers and others in responsible positions.

The Association successfully intercedes with SEC to preserve the “red herring” prospectus.

### 1946

“Free-riding” interpretation of Article III, Section 1 of Rules of Fair Practice.

Jan. 15 20,000 associated persons register under new requirements.

June NASD successfully testifies before Congress to oppose registration of over-the-counter securities issues having more than \$3 million in assets and over 300 stockholders.

### 1947

Abandonment of questionnaire method of examining members’ books in favor of staff examiners.

April 2 SEC abandons attempt to require disclosure of the best wholesale bid and ask prices for all transactions.

### 1948

Life insurance is offered to membership and is immediately accepted.

### 1949

Change in Regulation T from 7 calendar days to 7 business days and exemption increase to \$100 from \$50.

Wharton School Study is begun.

## Appendix A: Chronology of NASD History

- 1950      Revision of “Free Riding” Interpretation of Article III, Section 1 of the Rules of Fair Practice.
- Establishment of the Investment Companies Department and beginning of work on Statement of Policy.
- 1952
- Jan. 7      Association successfully appears before SEC and Congress to oppose payment of fees by members to SEC.
- Oct. 20     Supreme Court refuses to review the R. H. Johnson case which had been decided in favor of the NASD. Significance is:
1. Maloney Act is constitutional.
  2. Association may expel a firm for improper activity in connection with the account of a single customer.
  3. An individual officer, partner or employee may be named as a cause of an order.
  4. There must be effective supervision of personnel in their dealings with investors.
- 1956
- Introduction of qualification examination for associated persons.
- October     Introduction of National List of quotations in Wall Street Journal and other newspapers.
- 1958
- “History of the National Association of Securities Dealers, Inc.” published by Congress.
- There are 28 Rules of Fair Practice by this date.
- 1963
- SEC Report of the Special Study is published. Far-reaching reforms in self-regulatory bodies, including NASD, resulted from the study.
- 1964
- 1964 Amendments to the Securities Exchange Act of 1934 are promulgated, affecting NASD jurisdiction over individuals. SECO registration for broker-dealers is made possible.
- 1969
- Formation of National Clearing Corporation.

Appendix A: Chronology of NASD History

1970

Passage of SIPC Act.

1971

Feb. 8 NASDAQ becomes operative.

1972

H.R. 5050 Amendments proposed to the '34 Act.

House Securities Industry Study proposes that NASD be the sole agency for conducting broker-dealer examinations.

1973

S. 2159 Amendments proposed to the '34 Act.

1974

H.R. 14685, Stuckey proposed Amendment to the Securities Exchange Act of 1934.

## APPENDIX B: LISTING OF SECURITIES TRADE ASSOCIATIONS<sup>87</sup>

Some of these organizations perform or purport to perform self-regulatory functions. None, however, is registered with the SEC under the Maloney Act.

1. Securities Industry Association
2. Investment Company Institute
3. Association of Mutual Fund Plan Sponsors, Inc.
4. Investment Counsel Association of America, Inc.
5. Association of Real Estate Syndicators
6. Put and Call Broker and Dealers Association
7. National Association of Investors' Brokers
8. National Security Traders Association, Inc.

It should be kept in mind at this point that only one association has registered with the SEC under the provisions of the Maloney Act Amendment to the Securities Exchange Act of 1934. That is the NASD. While other securities associations promote ethical conduct and programs to improve industry standards, they have no enforcement programs to assure regulatory compliance among their members. Only the regulations of the NASD enjoy statutory sanction and official SEC overview. It has been pointed out<sup>88</sup> that, lacking official standing, the other associations might run afoul of anti-trust policy under the doctrine of Silver v. New York Stock Exchange if they attempted to enforce certain types of regulation.

\* \* \* \*

### 1. Securities Industry Association (SIA)

In 1971 the Association of Stock Exchange Firms and the Investment Bankers Association combined to form the SIA. The IBA had in the 1930's been responsible for the foundation of the NASD. The two merged associations had each been in existence for nearly sixty years.

SIA has no regulatory purposes but rather aims to be a trade association promoting the interests of its members. Among the goals it aims to achieve for its members are these:

1. Speak with a single voice in Washington and to the public.
2. Concentrate their efforts and volunteer activity in a single association.
3. Secure stronger representation of their interests.
4. Establish priorities and fix responsibilities in solving industry problems.
5. Increase the efficiency and responsiveness of services from their trade association.

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<sup>87</sup> 1963 SEC Special Study, Part 4, pp. 682-691.

<sup>88</sup> Ibid., p. 692.

## Appendix B: Listing of Securities Trade Associations

SIA's fundamental purpose is to provide a focal point of leadership for, and representation of, the interests of its member organizations. It had over 850 member firms in 1972.

### 2. Investment Company Institute (ICI)

Founded in 1940 to provide an authoritative voice for the industry with which the SEC might speak in forming the Investment Company Act of 1940, the ICI promotes ethical conduct among its members, although there are no sanctions for violation of the guidelines set down.

### 3. Association of Mutual Fund Plan Sponsors, Inc. (AMFPS)

Membership is restricted to firms sponsoring contractual plans. The goals of AMFPS are those of a trade association, and do not include self-regulation. One special feature is the right guaranteed all customers to cancel within 30 days the purchase of a plan, without specifying the reason.

### 4. Investment Counsel Association of America, Inc. (ICAA)

Membership is limited to firms whose business is to give continuous advice as to the investment of funds of its clients on the basis of the individual needs of each client exclusively on a fee basis. It is felt that the membership is in the best position to render service to investors since there is no ulterior motive behind the advice given, no stock commissions, and no trading profit to be gained.

### 5. Association of Real Estate Syndicators (ARES)

Members include syndicators, persons associated in a professional capacity with them, affiliates, i.e., persons such as brokers or salesmen having business relationships with syndicators, and financial affiliates, i.e., persons connected with financial institutions serving the real estate syndication business.

### 6. Put and Call Brokers and Dealers Association (PCBDA)

“The most highly organized of all the unofficial self-regulatory organizations...it was formed in 1934 to represent the interests of put and call broker-dealers during the congressional hearings that preceded the enactment of the Exchange Act and today includes among its membership virtually all persons engaged in that highly specialized occupation...Although the PCBDA has no official standing, the association has assumed as firm control over its members and the put and call market as certain official self-regulatory bodies have over their members and members' activities.”<sup>89</sup>

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<sup>89</sup> Ibid., pp. 687 and 690.

## Appendix B: Listing of Securities Trade Associations

### 7. National Association of Investors' Brokers (NAIB)

The NAIB has no individual members and only institutional members, namely, the Association of Customers Brokers (ACB), a New York organization, and the Stock Brokers Associates of Chicago (SBAC). Only registered representatives of New York Stock Exchange, American Stock Exchange or Midwest Stock Exchange firms may belong to these groups. Although the NAIB aims to promote high standards in the securities business, it does not purport to engage in a regulatory program nor does it have official standing.

### 8. The National Securities Traders Association, Inc. (NSTA)

Founded in 1934, it functioned primarily as a social organization designed to permit over-the-counter traders to become personally acquainted with other traders with whom they dealt over the telephone. To a certain degree, NSTA has served as an OTC industry trade association, trying to awaken public interest in OTC investment. It has not assumed any self-regulatory functions.

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NASD Annual Report  
Keynoting the NASD  
Understanding the Over-the-Counter Securities Market  
The NASD Story

### Training Materials Used for Registered Representatives and Principals

Training Guide  
What You Must Know  
Over-the-Counter Trading Handbook  
A Guide to Supervision Procedures

### NASDAQ

NASDAQ and the OTC  
NASDAQ – One Year Later: NASDAQ and the Issuer  
NASDAQ and the Listing Dilemma  
Directory of Security and Market-Maker Identifiers  
NASDAQ All Securities Report (Print or Tape)

### National Clearing Corporation

Member Operations Training Kit  
Security & Bond Listing

### Periodic Publications

NASD News  
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