

NASD

News

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BROKER INSURANCE PLAN PRESENTED TO CONGRESS

The securities industry, the SEC and the Congress are putting the final touches on a legislative package that will probably insure each investor up to \$50,000 if a brokerage firm should fold. This plan would cover customers' free credit and net equity balances—not losses sustained in the normal ups and downs in the market.

The proposed legislation resulted from agreements reached after a series of conferences between the SEC, the Industry Task Force, the Treasury, and is expected to have the general support of the Congress.

Such a program has been in the offing since Senator Edmund Muskie introduced a bill last summer which would have established a Federal Broker/Dealer Insurance Corporation patterned after the Federal Deposit Insurance Corporation which insures customers of banks for \$20,000 per account. Representative John Moss (D.-Calif.) later introduced a similar bill in the House.

The securities industry and the SEC felt that a private insurance corporation with all broker/dealers as members might be preferable to a government-controlled organization. After Mr. Muskie and Mr. Moss indicated that they were open to suggestions from the SEC and the industry, both the Commission and the specially created Industry Task Force headed by Ralph DeNunzio drafted suggested alternatives to the existing bills.

The industry and the SEC proposed bills were unveiled for Congressional scrutiny during Senate hearings last month. Statements before a Senate committee by DeNunzio and Hamer Budge, SEC Chairman, disclosed some major, but not insoluble, differences between the proposed industry and SEC bills.

The main areas of disagreement concerned (1) the size of an insurance fund that such a corporation should initially build up; (2) the amount of the assessments that should be levied against member firms belonging to the corporation; (3) the composition of the Board of Directors; and ultimately (4) the amount of control that the SEC would exercise over the corporation.

The SEC and the Industry Task Force immediately began meetings to reconcile the differences in their proposals. Details of the resultant compromise bill, which is supported by the Administration, the SEC, the industry, and the Treasury, were revealed on July 9 during hearings before a House Sub-Committee chaired by Mr. Moss. Highlights of the compromise bill are:

1. The Securities Investor Protection Corporation would be formed as a non-profit corporation with a 15-man Board of Governors—five Presidential appointees and ten representatives from major securities industry groups. The corporation would insure each investor up to \$50,000 in case of a brokerage firm's failure.
2. The insurance fund would consist of \$75 million within 120 days of adoption of the legislation and would be expanded to \$150 million within five years. The initial fund would consist of money raised by assessing each broker/dealer one-

eighth of one percent of his gross revenues from the securities business during 1969, plus necessary loans.

The minimum allowable assessment is \$250, and the maximum allowable assessment will not be more than one half of one percent of a member's gross revenues from the securities business during any given year. These assessments would be collected by a member's appropriate self-regulatory agency. However, the SEC is given authority to grant exemptions from the assessment rate for particular firms or classes of firms where public risk is minimal.

3. If additional funds are needed, the corporation would be able to borrow up to \$1 billion from the U. S. Treasury if the SEC certified that such a loan was necessary. The bill would give the Secretary of the Treasury the right to impose a \$.20 per \$1,000 transaction charge when Treasury funds are being used and he judges that SIPC does not have the necessary resources to cover the loan "repayment". This charge would be paid by the public.

4. The SEC would have the authority to require the corporation to adopt certain "financial responsibility" rules. A broker/dealer's appropriate self-regulatory agency would carry out examinations to determine if the firm is in compliance with these rules. These examinations will be part of an "early warning" system to discover if a firm is approaching financial difficulties. In addition, the Commission would have the power to require the self-regulatory agencies to adopt any specified alteration or supplement to its rules and/or procedures regarding the frequency and nature of financial examinations of the members.

5. In addition, the SEC will have oversight authority over the corporation and will be able to request the corporation to adopt or alter its by-laws, rules or regulations.

6. The proposed bill also contains detailed procedures to be followed if a member firm of the corporation declares bankruptcy.

NASDAQ PROGRESS REPORT

On the NASDAQ front all efforts are being geared to the operational date of late December, 1970. Installation of control units and terminals is progressing at the planned rate of approximately one-hundred a month in order to have all equipment ready by the end of the year.

An eligible list of securities for the NASDAQ system has been formulated and will continue to be up-dated as often as possible before the system begins operation. Recently, all Level 3 NASDAQ subscribers received a package containing the current eligible list, the revised qualification requirements for authorized securities under the system, and an application form for registration as a market maker for NASDAQ.

Generally, the eligible pool of securities which will be considered for NASDAQ contains any security covered under the registration requirements of the Exchange Act—an "equity security held by 500 or more persons and issued by a company with over \$1,000,000 in assets. This includes a variety of OTC stocks; warrants, rights, and convertibles; bank securities (registered with the Federal Reserve System, FDIC, or the Comptroller); and securities of foreign issuers operating mainly in this country. Also included are certain insurance company and closed-end investment company securities, plus foreign securities and ADRs if the foreign issuer is reporting to the SEC. Listed securities traded on the third market may also be eligible. A new issue may be placed in the eligible pool after the second day of its offering if the total assets of the issuer have reached or are expected to reach \$1,000,000 as a result of the public offering.

Securities from the eligible pool will only be authorized if certain other criteria are met. Generally there will have to be at least two market makers, public distribution of at least 100,000 shares, a minimum price of \$5, minimum capital and surplus of \$500,000 and compliance with certain disclosure standards.

The qualification rules will be administered on the basis of reports already filed publicly by the issuers. Therefore, if the NASD determines that a security should be authorized, it will be placed on the NASDAQ list.

If a security no longer meets the requirements for NASDAQ, its authorization will be suspended. Of course, if it again meets the necessary standards, it will be eligible for authorization.

The detailed rules for the authorization of securities for NASDAQ will appear in the revised Part II of Schedule D of the NASD By-Laws. This will appear in the NASD Manual.

**INSTITUTIONAL EXCHANGE
MEMBERSHIP PROHIBITED
BY RECENT BENNETT BILL**

The question of institutional membership in stock exchanges raised its head again last month when Senator Wallace F. Bennett (R.-Utah) introduced a bill which would prohibit institutions from belonging to stock exchanges. The bill (S. 4004) would only allow companies that are actually engaged as a broker/dealer in securities or whose parent companies are broker/dealers in the securities business to be members of a stock exchange. The bill is also sponsored by Senator John Sparkman (D.-California).

In introducing the bill, Senator Bennett pointed out that more than \$200 billion is controlled by mutual funds, banks, and insurance companies. Since institutional investors play a mighty role in generating sales commissions, Bennett stated that without these commissions, many brokerage firms would lose the mainstay of their business.

In addition, Bennett said that, given membership in an exchange, institutional investors could dominate the market and place small investors and business at a disadvantage.

The bill runs counter to a bill introduced last year by Senator Eugene McCarthy (D.-Minnesota). Mr. McCarthy's bill (S. 2742) would amend the Securities Exchange Act of 1934 to provide that no exchange could be registered unless any broker or dealer registered under the 1934 Act could become a member of the exchange. This bill, in effect, would open exchange doors to institutional membership.

**MATTHEWS APPOINTED
NASD VICE-PRESIDENT**

The NASD has announced that William A. Matthews has been named a vice president of the organization. Matthews will continue to serve as Director of the Association's Investment Companies and Advertising Departments. These departments engage in many activities related to the mutual fund area, including the review of all sales literature for investment company shares and sales literature and advertising concerning the general securities business.

A graduate of George Washington University Law School, Matthews began his career by clerking for the Hon. Oliver Gasch, United States Attorney for the District of Columbia, from 1957 to 1961. In 1961 he joined the staff of the Securities and Exchange Commission as a Trial Attorney for the Division of Corporate Regulation. From 1965 to 1968, he served as Special Counsel for the SEC, and in 1968 he became Branch Chief, Division of Corporate Regulation, for that organization. He left the SEC in April of 1969 to become Director of the Investment Companies and Advertising Departments for the NASD.

Matthews is a member of the American Bar Association, the Federal Bar Association, the American Judicature Society and the Phi Delta Phi Legal Fraternity.

**SEC CONTEMPLATES
NEW RESTRICTIONS ON
FUND SHARE DISCOUNTS**

In June, the Securities and Exchange Commission announced its proposal to amend Rule 22d-1 under the Investment Company Act of 1940 in order to preclude most exemptions from the public offering price requirements in the rule. Section 22-(d) has as its purpose the prevention of discrimination among purchasers of mutual fund shares by requiring all sales at public offering prices stated in the fund prospectus.

The Association, while generally opposed to any erosion of this section, has supported certain exemptions allowing the offering of investment company shares at a reduced or eliminated sales load to those working for the investment company, its investment adviser and its principal underwriter. These exemptions have had NASD backing because the Association is aware that it makes good sense to encourage investment by officers, directors and employees in the stock of their corporations. Such investments usually lead to closer identification with the aims of the corporation, as well as fostering a greater sense of responsibility and interest among these individuals.

The NASD, however, has stressed that these exemptions should not include exemptions in connection with sales made to large numbers of persons whose activities are unrelated to the investment company and its activities. For example, several investment companies requested exemptions from Section 22-(d) for all of their employees, including those in subsidiary companies in such far-ranging fields as car rental services and home building. The Association subsequently persuaded some of these companies to ask for exemptions limited to employees directly involved in the company's insurance and financial activities.

In its comment to the SEC regarding the proposed rule change, the NASD stated that it would favor any amendment to Rule 22d-1 which would establish logical criteria for determining who would be eligible to purchase investment company shares at less than the public offering price.

However, the NASD believes that there are problems inherent in the SEC proposed rule. The rule states that "no natural person now described in the rule who is not a director, officer, partner or full-time employee of the investment company, nor any trust, pension or profit-sharing or other benefit plan for such person shall be entitled to exemptive treatment unless more than one-half of his working time involves (i) rendering investment advisory services to the investment company or (ii) selling the investment company's shares."

The NASD pointed out to the Commission that it felt that this language was unduly restrictive. It appears that under the terms of the proposed rule, administrative personnel and some individuals such as senior officers of the principal underwriter, the investment adviser, and other employees who sell fund shares and give investment advice could be ineligible for purchases of shares at less than the public offering price.

Part time mutual fund salesmen present yet another problem. The Association asked the SEC if these individuals would be eligible for a discount if their time spent in mutual fund sales activities is less than that spent at their regular employment. Concerning insurance salesmen, the NASD remarked that although the dollar amount of an insurance salesman's sales of mutual fund shares might represent a small portion of his total sales, he might be said to be offering, *i.e.*, selling, these shares at all times.

In other words, the Association believes that it would be difficult, if not impossible, to determine specific criteria for the allocation of an employee's time spent in the securities business.

Accordingly, the Association suggested to the SEC that "at the very least, any amendment should continue to permit all bona fide employees of principal underwriters and investment advisers to continue to receive the benefits of the lower price, regardless of whether their activities are directly related to selling or advisory functions."

**WITHDRAWAL/REINSTATEMENT
MUTUAL FUND CASE IS WON
BY NASD, GROWTH PROGRAMS**

Last month the U.S. District Court of Western Texas ruled in favor of the NASD in a class action suit which tested the Association's authority to restrict NASD members from using or encouraging the use of withdrawal and reinvestment privileges in contractual plans for speculative purposes. For the full text of the Court's opinion see Commerce Clearing House Federal Securities Law Report 92694.

The case (Norman C. Harwell, et al. Vs. Growth Programs, et al.) began when certain investors holding single investment programs issued by Growth Programs, Inc., brought suit against Growth Programs for breach of contract involving the limiting of the exercise of the withdrawal and reinstatement privileges contained in their contracts. In changing this option, Growth Programs was responding to an NASD directive.

This privilege had been included in contractual plans since at least the 1930's. Its purpose is to enable planholders to withdraw up to 90% of the money they had invested in a contractual plan in case of an emergency and to later repurchase shares at the net asset value to the extent of the total amount withdrawn without incurring an additional sales charge.

Before 1965, there was little or no problem regarding the use of this privilege. However, beginning in that year, a number of investors taking advantage of relaxed procedures by certain contractual plan sponsors utilized the privilege on an "in and out" basis. For example, investors in Growth Programs could exercise this privilege an unlimited number of times and on an instantaneous basis. The situation was accentuated by some broker dealers who obtained a power of attorney from many or all of their clients holding the contractual plans and often executed a withdrawal or a reinvestment for all of them simultaneously.

This situation led to excessive withdrawals for speculative purposes. For example, Growth Programs was often experiencing a turnover of millions of dollars a month. As a result, Growth Programs became concerned and consequently restricted the exercise of the privilege to four times a year even before action was taken by the Association. The problem, in turn, concerned the NASD, the SEC and the Association of Mutual Fund Sponsors. These organizations were worried about increases in speculative activity and the dilution of the value of the shares in the underlying fund.

In the summer of 1966, the NASD, with SEC backing, went a step further and issued the Board of Governor's Interpretation which prohibits all NASD members from using or encouraging the use of the privilege for speculative purposes. Growth Programs complied with this directive, thus, according to the plaintiffs, breaking its contract with them.

In the suit which resulted, the plaintiffs attempted to establish that their contracts were valid and that the NASD had unlawfully interfered with these contracts in issuing its interpretation. The plaintiffs argued that the NASD was an ordinary non-profit organization without the power to issue such a rule.

The Court disagreed. The opinion held that the NASD was acting properly under the authority granted by the Maloney Act, particularly since the Association had received full approval from the SEC. The Court also held that the requirements of the Interpretation were reasonable.

In addition, the decision stated that since Growth Programs is a member of the NASD that it is "bound . . . to abide by all rules, regulations, orders and interpretations issued . . . by the Association." Therefore, the Court stressed that Growth Programs "cannot be held liable for breaching their contracts with Plaintiffs because they were ordered to do so by the NASD. To hold otherwise would seriously disrupt the statutory scheme of self-regulation established by the Maloney Act."

The plaintiffs also claimed that the NASD and its members were in violation of the antitrust laws. The Court's opinion, in rebuttal of this claim, stated that "when, as in this case, the NASD is acting in the quasi-governmental rulemaking capacity given to it by the Maloney Act, and is acting under the close supervision of the SEC, it is immune from antitrust suits."

MANAGEMENT & SUPERVISION

NOTES

NEW YORK TRANSFER TAX PAID FOR NON-RESIDENTS

NASD members are reminded that the New York stock transfer tax on sales made by individuals who qualify as non-residents of New York was reduced on July 1, 1970. From this date until June 30, 1971, the tax rates will be:

Selling Price Per Share	Rate in Cents
Less than \$5	1.125
\$5 to less than \$10	2.25
\$10 to less than \$20	3.375
\$20 or more	4.5

During this period, \$1,250 will be the maximum tax on a "single taxable sale." This maximum tax applies to all sales made by a resident or a non-resident.

Any questions regarding the new rates should be relayed to James R. Yore, Jr., Secretary, Uniform Practice Committee, NASD, 17 Battery Place, New York, New York 10004.

NASD FINES MEMBER FOR FAILURE TO OBTAIN BEST PRICE FOR CUSTOMERS

In a recent disciplinary case, an NASD member firm was fined and censured for failure to obtain the best possible execution for its customers. The violation of the Association's Rules of Fair Practice occurred when the firm sold bonds for its customers at less than the syndicate bid which was still in effect.

The firm was part of the selling group for a new bond issue. In order to facilitate the distribution of this new issue, a maintenance bid at par was established by the firm heading the syndicate. During the same time, a "discount" or "going-away" market developed for the bonds, with published bids existing that were as low as 94.

Before the trading restrictions were lifted regarding this new issue, the firm executed three transactions for customers which involved selling bonds for

these customers at prices of 91 and 92—much less than could have been obtained if the bonds had been sold to the head of the syndicate at par. The Board of Governors found that the firm was in violation of Section I of Article III of the Association's Rules of Fair Practice, since it had an obligation to obtain the most favorable price possible for its customers. The Board of Governors determined that the firm had failed to exercise reasonable diligence in determining if a stabilization bid remained in effect which represented the best available market for the bonds.

FINANCIAL REPORTING TO BE INAUGURATED ON QUARTERLY BASIS

During the May NASD Board of Governors meeting, a resolution was adopted which will require quarterly financial reporting by all members. This action was taken following strong urging by the Securities and Exchange Commission.

The purpose of more frequent reporting is to provide early warning of possible impending financial or record-keeping crises in NASD member firms. Through keeping tabs on members' financial situations, the NASD will both be in a position to inject help when necessary and also to more effectively fulfill its self-regulatory responsibilities.

Accordingly, the NASD staff has drafted two versions of a quarterly report form—one a three-page form to be filed by smaller firms and those specializing in retailing mutual fund shares, and the other a four-page form to be filed by all other firms. To minimize any inconvenience caused member firms, the Association has patterned the quarterly report form after the balance sheet and capital funds statements in the annual financial report form (NASD Form 17A-10).

The Association plans to inaugurate the quarterly reporting program in the early fall. Members will be given advance warning in order to gear up for this new requirement.