COMMENTS OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
ON S. 2519, 93d Congress, 1st Sess.
(NOVEMBER 8, 1973).

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General Overview

S. 2519 represents another in a series of legislative proposals emanating from the Subcommittee. Prior proposals include: (1) S. 470, governing, among other things, exchange membership, fixed commission charges on exchanges and the payment of commissions by investment advisers; (2) S. 2058, governing transfer agent and depository functions, (3) S., 2234 governing the disclosure of certain institutional portfolio holdings and transaction; and (4) S. 2474, governing certain trading in municipal securities. Similar legislative initiatives are in progress in the House of Representatives. While our section-by-section analysis of S. 2519 is set forth below, there follow some of the Commission's general observations with respect to S. 2519.

The major purposes of S. 2519 are to facilitate the development of a central market system, to render more nearly comparable the Commission's oversight of national securities exchanges and national securities associations and to improve and strengthen the Commission's oversight of self-regulatory organizations. While the Commission believes it has authority under existing legislation to structure a central, or national, market system, explicit authority in this regard certainly is desirable to obviate the need to defend its authority at every step, and the Commission strongly supports the Subcommittee's general efforts to accomplish this.

The remaining two major goals -- comparability and strengthening of Commission oversight of self-regulatory organizations -- are the same ones the Commission has been seeking to have implemented by legislation since the completion of its Unsafe and Unsound Practices Study.[1] The Subcommittee's approach is not precisely the same as that which we have previously advocated. Our differences in this regard also are not set forth below. One general difficulty we perceive, however, appears worth noting at this juncture. The proposed legislation is not consistent in its attempt to combine provisions of the Act relating to exchanges and securities associations. For example, the proposed legislation continues separate and somewhat disparate treatment for the registration of national securities association and national securities exchanges. Other examples of this disparity of treatment also exist.[2] To the extent it is possible to provide unified treatment for the registration of both kinds of self-regulatory organizations, we believe this would be desirable.

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[1] Study of Unsafe and Unsound Practices of Brokers and Dealers, (H.R. Doc. No. 92nd Cong., 1st Sess. (1971)).

[2] Compare, for example, proposed Section 6 (b) (6) with proposed Section 15A (b) (5).

In this context, we also note that S. 2519 does not appear to take cognizance of other legislative proposals previously developed. For example, S. 2519 does not incorporate broad reference to the possible future existence of other self-regulatory bodies, such as the proposed self-regulatory body for municipal securities dealers (see, e.g., proposed Sections 3 (a) (3), 3 (a) (21) and 3(a) (23)).

Section 1. The National Securities Market System Act of 1973 (hereinafter referred to as the "bill") is directed in part, toward the development and regulation of a national market system. In keeping with this purpose, Section 1 of the bill proposes to amend Section 2 of the Securities Exchange Act of 1934 (the "Act") to add to the stated purposes of the Act the removal of impediments to and the perfection of the mechanism of a national securities market system. The Commission wholeheartedly concurs in and supports the bill's goal of seeking to establish a framework within which a central, national market system can evolve. Thus, we believe the proposed amendment to Section 2 is appropriate.

Section 2. Section 2 of the bill could amend Section 3 (a) (3) of the Act, which presently defines the term "member" when used with respect to an exchange. The current definition, which would be deleted, states that a "member" is any person permitted to effect transactions on an exchange without the use of another person acting as a broker or dealer, without the payment of a commission, or with the payment of a commission which would be less than that charged the general public. It also includes any firm transacting business as a broker or dealer of which a member is a partner (and any partner of such a firm). Proposed Section 3 (a) (3) would define a member, with respect to either an exchange or a registered securities association, as a broker or dealer which has agreed to be regulated by an exchange or registered securities association and with respect to which such exchange or association has undertaken to enforce compliance with its rules, the Act and the rules and regulations thereunder.

Given the manner in which exchange "seats" currently are held by most firms, we believe that for regulatory as well as most other purposes it is anachronistic to preserve the concept of individual membership on an exchange without providing for firm membership. Proposed Section 3 (a) (3) therefore properly unites the two concepts in its definition of a member.

The notion of a fixed number of "seats" or memberships on exchanges is also an outmoded concept, i.e., inconsistent with the goals of an open, competitive national market system. It still retains its significance, however, in relation to presence on exchange floors and voting rights. We believe these matters should be dealt with by amendments to the Act specifying, respectively, that an exchange may limit the number of designated

representatives of its members permitted to effect transactions on the floor and that the allocation of voting rights among members is to be determined in accordance with such rules as the Commission may promulgate or in accordance with rules of an exchange which would be subject to Commission review.

The proposed amendment to Section 3 (a) (3) also would eliminate any potential confusion concerning the status of brokers executing unaffiliated customer orders on exchanges through members of exchanges at non-member discount. The Commission has taken the position that such brokers may be treated as a special class of customers with respect to the obligation of an exchange to regulate its members. The proposed definition contained in S. 2519 would eliminate any ambiguity concerning this administrative view and a technical application of the literal language of Section 3 (a) (3). It would not, however, resolve the substantive question of what an exchange's authority and responsibility should be with respect to non-member brokers who gain access to exchange facilities through a member of the exchange.

In the environment of a national market system for listed securities, it should be common for brokers to execute transactions on exchanges of which they are not members. It seems reasonable that, at a minimum, exchanges should have the right and the duty to ensure that such transactions take place in accordance with applicable exchange rules. Even though an exchange clearly would have this right and duty with respect to those members actually executing the transaction, there would appear to be a regulatory need in certain cases for the exchange to be able to extend its jurisdiction to the non-member who initiates these transactions. For example, if the exchange suspects a non-member of executing unmarked short sales on the exchange, it may not be enough to require the executing member to produce its records; recourse to the broker actually initiating the order or carrying the account may be essential.

The Commission believes that one way to empower exchanges to exercise this kind of limited regulatory authority over non-member brokers utilizing their facilities is by means of an amendment to paragraph (j) of proposed new Section 11A (contained in Section 7 of the bill). In its present form, that paragraph would authorize the Commission to regulate exchange transactions effected by a non-member with the services of another person acting as a broker. We suggest the addition of the following language at the end of that paragraph:

> "or by any other broker (other than a member of such exchange) through a member of such exchange."

The Commission, by rule, could establish conditions pursuant to which exchanges could regulate transactions effected by non-member brokers through exchange members, should it be appropriate to do so.

Section 3. Section 3 of the bill would broaden the definition of the term "person associated with a member" (presently defined in Section 3 (a) (21)) of the Act to include a person registered with a national securities exchange or associated with a broker or dealer which is a member of such an exchange, as well as a person registered with or associated with a broker or dealer member of a registered securities association. The expansion of the definition to cover exchanges is consistent with the bill's goal of establishing uniform Commission regulation for both national securities exchanges and registered securities associations, which we support. Nevertheless, we perceive some difficulties in the implementation of this concept by the Subcommittee. As presently drafted, proposed Section 3 (a) (21) refers to "a person who is registered with a registered securities association or national securities exchange …" (emphasis supplied), but there is no statutory definition furnished for the concept of registration with a securities association or exchange. Moreover, this proposed section would define the term "person associated with a member" in tautological terms -- viz., "a person who … is associated with a broker or dealer which is a member of …" an association or an exchange. We think this portion of the subsection should be modified.

Section 4. Section 4 of the bill would amend Section 3 (a) of the Act by adding new paragraphs (22) and (23), which define, respectively, the terms "securities information processor" and "self-regulatory organization."

A "securities information processor" would include any person engaged in the business of collection, processing or publishing information relating to quotations or transaction in any securities, including exempted securities. The financial press, state and federally regulated common carriers, national securities exchanges and registered securities associations would be excluded from the definition. The proposed language dealing with the exclusion of the financial press differs somewhat from a similar exclusion contained in Section 202 (a) (11) (E) of the Investment Advisers Act of 1940. In order to conform the proposed amendment, we recommend deletion of the phrase "any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation …" and insertion in place thereof the following:

> "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation …"

We understand that it is the purpose of the Subcommittee to include within this definition, among others, the Securities Industry Automation Corporation ("SIAC"), a wholly-owned subsidiary of the New York and American Stock Exchanges; but the proposed language exempting exchanges and registered securities associations could be construed to except SIAC and any other instrumentality owned or controlled by an exchange or securities association. To prevent such a misinterpretation of Congressional intent, the Commission recommends that the Committee's Report make clear that such an entity would be included within the definition.

Because of the breadth of the definition, it is possible that some entities or market facilities not really engaged in the business of acting as information processors, as that term is

generally understood, arguably might come within its terms. This may be particularly true in respect of the markets for exempted securities. We are uncertain as to whether this is the bill's intention and suggest that this point be clarified in the Committee's report.

Section 4 also defines the term "self-regulatory organization" as a national securities exchange or a registered securities association. It is not clear whether newly created entities which have self-regulatory responsibilities such as the proposed National Association of Municipal Securities Dealers would be included within this definition. The Commission recommends that the Subcommittee clarify its view in this regard.

Section 5. Section 5 of the bill would amend Section 6 of the Act, which provides for registration with the Commission of national securities exchanges. Paragraph (1) of proposed Section 6 (a) specifies a list of documents which would be required to accompany a registration statement submitted by an exchange. As amended, this list would include a number of documents presently listed in paragraph (3) of Section 6 (a) (an exchange's constitution, articles of incorporation, rules and bylaws) and would add documents not currently required as attachments (stated policies and practices relating to an exchange's organization, membership, rules of conduct, financial condition and methods of trading).

Paragraph (2) of proposed Section 6 (a) provides that a registration statement also would have to be accompanied by such other information and documents as the Commission may prescribe. Proposed paragraph (2) does not provide a sufficient standard by which the Commission may determine what additional documentation is to be required of an applicant. Accordingly, we suggest the paragraph be amended to require the Commission to apply the standard presently applicable -- that the furnishing of additional documents be necessary to appropriate in the public interest or for the protection of investors.

Proposed Section 6 (b) sets forth detailed standards which an exchange seeking registration would be required to meet. Paragraph (1) would require that an exchange be organized so as to comply with and to enforce its members' compliance with the Act, the rules and regulations promulgated thereunder and the rules of the exchange. Paragraph (2) would require that exchange members be fairly represented with respect to rulemaking, election of officers and administration of the exchange. Paragraph (3) would require that the rules of an exchange provide for an equitable allocation of dues, fees and other charges to be borne by all persons or organizations utilizing exchange facilities This latter paragraph, as amended, would make clear that exchanges can take steps to relieve members to some extent of the financial burdens of the exchange when exchange facilities are utilized by non-members of the exchange.

Proposed paragraph (4) requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade and to prevent fraudulent and manipulative acts and practices. It also adds a new standard: "to foster cooperation and coordination with other exchanges, registered securities associations, registered securities information processors" and others. The Commission supports this addition. Proposed paragraph (4) also requires exchange rules "to provide safeguards against unreasonable profits or unreasonable rates of commission or other charges." We assume that this clause was simple, intended to grant the exchange residual authority over "gouging" such as is contained in NASD rules relating to "mark-ups". We believe that the "just and equitable principles of trade" clause would permit rules designed to prevent such overreaching of customers. Combined with traditional disclosure rules, applicable whether or not commission rates are fixed or competitively determined, the necessary public protections are provided without the addition of the above referred to language. Nevertheless, if the Subcommittee retains such language, it should be made clear that it is not intended to place exchanges or the Commission, contrary to other provisions of paragraph (4), in the business of determining the reasonableness of commission rates, profits and charges.

The paragraph also provides that the rules of an exchange should not be designed "to regulate matters not related to the protection of investors." Such a provision, if taken literally, would seem to prohibit an exchange from adopting rules governing the conduct of its members which are not directly related to the investment business, i.e., members' sales of insurance and real estate. In fact, it might appear that housekeeping rules governing the scheduling of board meetings and the time of exchange elections would be prohibited as matters unrelated to the protection of investors. The Commission believes that the proposed paragraph should be further amended to specify that an exchange may properly adopt rules governing matters not directly related to the protection of investors for the purpose, at least, of providing for the orderly administration of the exchange. In addition, we believe the language which concludes paragraph (4), which would prohibit an exchange from imposing "any burden on competition not reasonably necessary to achieve the purposes of this title," is inappropriate. Similar language is also found in other provisions of the bill (see proposed Sections 15A(b) (8) and 19 (b). Many exchange or association rules, such as rules of conduct or admission requirements, are, by their very nature, restrictions on competition. Nevertheless, these rules may upgrade standards of professionalism in the industry and thus may be highly desirable (e.g., membership qualifications). The Commission, therefore suggests that the applicable standard should be whether a particular action is within the scope and purposes of the Securities Exchange

Act[3] and that this standard should be substituted for the standard set forth on page 6, lines 10-12, and elsewhere in the bill where that standard appears.

Section 15A (n) of the Securities Exchange Act provides that if any law, including the antitrust laws, is in conflict with Section 15A of the Act, relating to the registration and regulation of national securities associations, the latter provisions are to prevail. Although the Subcommittee proposes to repeal Section 15A (n), the Commission believes, as reflected in its comments on Section 15 of S. 2519, that Section 15A (n) should be retained. Moreover, we believe that Section 15A (n) should be amended so as to be applicable also in the case of provisions relating to the registration and regulation of national securities exchanges and other self-regulatory organizations.

Proposed paragraph (5) requires a national securities exchange to provide in its rules that its members, and persons associated with its members, will be "appropriately disciplined" for violations of the Act, the rules and regulations promulgated thereunder and the rules of the exchange. Paragraph (5) has been modeled after paragraph (9) of Section 15A (b) of the Act, dealing with national securities associations. Paragraph (9) of Section 15A (b) designates a number of specific remedial sanctions which must be provided by the rules of a national securities association and includes a general category, "or any other fitting penalty," to permit an association broad latitude in formulating remedial sanctions. Proposed paragraph (5) does not contain this broad language but adds "limitations of activities, functions, and operations," as well as fine or censure. Although these sanctions provide more flexibility than suspension or withdrawal, the Commission believes that exchanges (and national securities associations) also should be afforded the broader latitude provided by the "fitting penalty" language of existing paragraph (9) of Section 15A (b). Furthermore, we assume it is not the intention of paragraph (5) to limit the sanctions that would be available against persons associated with a member. If read literally, it might appear that "persons associated with a member" could only be sanctioned by suspension or bar from association with any member. The Commission believes that this ambiguity should be eliminated either by an amendment to paragraph (5) to clarify that the full range of sanctions provided in the paragraph apply to persons associated with a member or by specific reference to such an intention in the legislative history accompanying this bill.

[3] See Silver v. New York Stock Exchange, 373 U.S. 341, 361 (1963).

Proposed paragraph (6) would require the rules of an exchange to provide a fair and orderly procedure by which members may be disciplined and membership by brokers and dealers or access by customers and issuers may be denied. The Commission suggests that such a procedure be required with respect to "any person" rather than merely to "customers or issues." For example, non-member brokers should have protection against summary denial of access to the facilities of an exchange. In addition, the Commission believes that the procedural requirements set forth at lines 4-15 on page 7 of the bill should be made specifically applicable to a denial of association with a member; they presently are provided in paragraph (10) of existing Section 15A (b) in respect of persons associated with members of a national securities association.

Section 13 of the bill would amend paragraph (10) of Section 15A (b) of the Act to provide specific procedural requirements applicable to disciplinary proceedings which a national securities association may bring against a member or other person. The Commission believes that similar language should be included in Section 5 of the bill, thus guaranteeing minimum procedural fairness to persons subject to discipline by an exchange.

Proposed Section 6 (c) of the Act would prescribe new statutory limits upon the time within which the Commission would be required to grant the registration of a national securities exchange or to take appropriate administrative action to determine whether such an exchange's application should be denied. If the Commission does not grant an application within a specified time period it must institute further proceedings to determine whether the application should be denied. Among other things, the Commission would be required to give notice of these proceedings and state the grounds for denial which it had under consideration. We are concerned that under the procedures specified, the Commission would be accused of prejudging whether an application is to be denied, and accordingly recommends that the Subcommittee delete this requirement.

In this proposed subsection of the Act, as in others, the Subcommittee has created new procedures pursuant to which the Commission must perform its adjudicatory and policymaking functions. The Administrative Procedure Act ("APA"), as the Subcommittee is aware,, was adopted precisely for the purpose of establishing uniform minimum agency procedures -- procedures that were intended to be applicable to all agencies of the federal government. We are unaware of any reason why the Commission's performance of its adjudicatory and policymaking functions should differ from the procedures applicable to other agencies and non is indicated in this Subcommittee's report on the securities markets. In this connection, we believe the Subcommittee should delete the reference in proposed subsection 6(c) to a 180-day time limit within which the Commission must act on registration

applications filed by securities exchanges. The APA explicitly covers unreasonable delay by administrative agencies, offering judicial review to persons who suffer legal wrong or who are adversely affected or aggrieved by an unreasonable delay in agency action. [4]

Proposed Section 6 (c), as drafted, would require the Commission to grant an application of a national securities exchange if all of the criteria set forth in the Act were met and to deny an application if any of the criteria have not been met. We assume the Commission could deny registration in the face of technical compliance with proposed Section 6 of the Act, if the public interest so requires, but this fact should be made explicit in the draft legislation. Similarly, while authority for the Commission to grant a conditional registration may be implicit in the language of the Section as drafted, we recommend that the Commission be given explicit authority to grant a conditional registration when not inconsistent with the public interest.

Except as noted above, the Commission generally endorses the changes proposed by Section 5 of the bill.

Section 6. Section 6 of the bill would amend Section 11(b) of the Act to allow the Commission by rule to require or permit specialists to disclose limit orders on their books to such persons as the Commission may designate.

As discussed in the Commission's March 29, 1973 Policy Statement of the Structure of a Central Market System, Price priority for public orders is considered of prime importance by the Commission in the development of a central market system for listed securities. To assure price priority for public orders, it is necessary that all members of the system have access to all such orders represented within the system at any given time. The Commission's Policy Statement suggested one method by which this could be achieved: an electronic central repository for all active limit orders. Nevertheless, some commentators have questioned the feasibility of such a system, and it is evident that should the repository prove impracticable, an alternative will be needed. It has been suggested that an "open book," which would make public each limit order entered into the system, could provide such an alternative. Proposed Section 11(b), in conjunction with proposed Section 15(c) (6)[5] of the Act (concerning regulation of non-specialist market makers), would provide for an open book by

[4] Section 10 (e) (1) of the APA, as codified, 5 U.S.C. 706 (1).
[5] See our comments on Section 11 of the bill.

authorizing the Commission to require all market makers, whether operating on or off an exchange, to disclose to such persons as the Commissions may designate the limited price orders which they hold. Presumably, the Commission also would be empowered to determine the manner in which such disclosure is to be made, but in order to make this more clear, we suggest that line 20 on page 9 of the bill be amended to add the phrase "in such manner and under such conditions" after the word "persons." This provision would give the Commission more discretion with respect to disclosure of limit orders than Section 11(b) presently provides.

Because of additional flexibility the proposed amendment to Section 11(b) would provide the Commission in its efforts to achieve the widely-shared goal of according price priority to public orders, the Commission supports this section of the bill.

Section 7. Section 7 would add a new Section 11A to the Act granting the Commission extensive regulatory authority over securities information processors and over the collection, processing, distribution and publication of quotation and transaction information. Section 11A also would authorize the Commission to regulate exchange transactions effected by a non-member without a broker (presumably this would include transactions between investors and exchange members acting for their own accounts) and would direct the commission to take whatever steps are within its power to ensure equal regulations, where appropriate in terms of the purposes of the regulations, for brokers, dealers, exchanges, securities associations, securities information processors and investors.

The Commission concurs in the subcommittee's view that automated communications systems for the dissemination of transaction and quotation information will provide the foundations for a national market system and that the Commission's authority and responsibility must be expanded to encompass the regulation of persons operating and administering such systems.

Specifically, proposed section 11A of the Act would empower the Commission to assure that all brokers and dealers have access on reasonable terms to all services available through any securities information system, to review any exclusionary action taken by a securities information processor and to promulgate rules to facilitate the prompt, accurate and reliable collection, processing and distribution of quotation and transaction information. Proposed Section 11A also would authorize the Commission to promulgate rules to prevent the publication of fraudulent or manipulative information with respect to quotations and transactions; to specify the form and content of and the method and manner by which quotations and transaction reports are published; to allocate among self-regulatory organizations and registered

securities information processors the costs, functions and responsibilities associated with the collection, processing and distribution of quotation and transaction data; and to require disclosure of all securities transactions which utilize the jurisdictional means, including those which take place in the so-called fourth market. The Commission believes this broad grant of authority over the operations of securities information processors is important if a national market system is to be developed.

Several caveats appear in order. Proposed paragraph (1) of Subsection 11A(a) makes it unlawful for any securities information processor to use the mails or interstate commerce unless registered with the Commission. The Commission, by rule, may exempt under certain conditions any securities information processor or class of securities information processors from any provision of this section or rule or regulation prescribed thereunder. In the interests of administrative flexibility, we believe the Commission should be empowered to exempt securities information processors by order as well as by rule. For example, an order would be a more appropriate means by which the Commission could act to exempt a particular processor rather than a class of processors. In addition, we believe that the standard the Commission would be required to apply in determining whether an exemption from the requirements of this section should be granted may prove cumbersome. Rather than having to find that regulation of a particular securities information processor is "neither necessary nor appropriate in the public interest or for the protection of investors," the Commission should be authorized to grant exemptions where it finds that such exemption "is not inconsistent with the public interest or the protection of investors." We believe this standard should be substituted in other provisions of the bill which grant exemptive powers to the Commission.

Proposed Section 11A(c) provides procedures relating to the grant or denial of an application for registration of a securities information processor. Since the procedures are the same as those set forth in the proposed Section 6(c), the Commission's comments on that section are equally applicable here.

Subsection (g), which deals with Commission rulemaking authority with respect to reports of transactions in securities, appears so broad as to comprehend the full details of all trades, including information of the kind required by S. 2234 (the Institutional Investor Full Disclosure Act). We question whether the Committee intended this result.

Subsection (h) would appear to require the Commission to adopt rules to assure that quotation and transaction reports in <u>all</u> non-exempted securities are available to all registered brokers

and dealers (and, on a potentially more limited basis, to all investors). Although we doubt the Subcommittee so intended, this language could be construed to preclude the Commission from distinguishing between listed and unlisted securities in acting to require quotation and transaction reporting in listed securities prior to mandating it for all securities would seem highly desirable. We suggest that the bill be modified to clarify that such flexibility indeed was intended to be available.

Item (3) of subsection (h) of proposed Section 11A (lines 17 through 24 of page 15 of the bill) grants rulemaking authority for the Commission to provide "for the fair and reasonable allocation among national securities exchanges, registered securities associations, and registered securities information processors of the costs, function, and responsibilities . . . and the development, operation, and regulation of a national market system." We recommend that the substance of this subsection be included in proposed Section 17(c) inasmuch as both sections refer essentially to similar if not identical allocations.

Proposed subsection (i) provides for Commission review of any prohibition or limitation of access to services offered by a securities information processor. We assume that paragraph was intended to cover not only refusals to commence new services but also any restriction of any existing service. If this is the case, it may be desirable to provide for some form of hearing prior to any restriction of an existing service. In addition, to avoid the possibility of an unnecessary irreparable harm, provision should be made for stay of such a restriction pending Commission review. If a hearing is to be required, we would suggest that the institution of review by the Commission not operate as a stay unless the Commission otherwise orders, after notice and opportunity for the presentation of views on the question of a stay; if no hearing is to be required, we believe the commencement of any such proceeding should operate as a stay of the restriction unless otherwise ordered by the Commission.

Pursuant to proposed Section 11A(i), the Commission would be required to dismiss a review proceeding under this section if it finds that the prohibition or limitation is consistent with the provisions of the Act and, among other things, that no burden has been placed on competition not reasonably necessary for achievement of the purposes of the Act. As hereinbefore noted with respect to proposed Sections 6(b)(4) and 11A(a)(1), we believe these standards to be unnecessarily stringent. We therefore would recommend that the Commission be authorized to dismiss a review proceeding pursuant to this section if it finds, among other things, that a limitation or prohibition is not inconsistent with the public interest or the protection of investors and that it is necessary or appropriate within the scope and purposes of the Securities Exchange Act.

A suggested modification in proposed paragraph (j) is contained in the discussion of Section 2 of the bill.

Finally, although the Commission has no objection to providing in its annual report to Congress information concerning exemptions from Section 11A (as would be required under proposed Section 11A(a)(2) of the Act), which will be a matter of public record in any event, good order would appear to dictate the such legislative mandates requiring the transmission of specific information to Congress be aggregated in the Act. Perhaps Section 23(b) could be revised to achieve this result. Accordingly, the Commission recommends that proposed Section 11A(a)(2) be deleted from the bill and its subject matter covered elsewhere, id deemed essential.

Section 8. Section 8 of the bill would amend Section 12(f) of the Act to permit an exchange to extend unlisted trading privileges to any security registered under Section 12 of the Act, or any security exempted from the registration requirements by virtue of Section 12(g)(2)(B) or 12(g)(2)(G) (applying respectively to investment company securities registered under Section 8 of the Investment Company Act and certain issues of insurance companies), upon application to an approval by the Commission, even if such security is not listed on any stock exchange. It also would establish various criteria to be considered by the Commission in determining whether an exchange's application for unlisted trading privileges in a particular security should be approved.

Our views on this subject are expressed in some detail in a latter dated September 28, 1973 from Lee A. Pickard, Director of the Commission's Division of Market Regulation, to Harvey A. Rowen, Special Counsel to the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce. A copy of that letter is enclosed for your information.

It appears that the language of the bill would satisfy the conditions set forth in our letter, with one exception: it does not include the status of developments toward a national securities market system as a factor to be considered by the Commission. We believe this to be an important factor because the arguments supporting this kind of unlisted trading draw their force from the competitive principles on which such a system will be based. With a modification to correct this omission, amended Section 12(f) will have our support.

Section 9. Section 9 of the bill would amend Section 12(j) of the Act to permit the Commission "by order to deny, to suspect the effective date of, to suspend for a period not exceeding twelve months, or to withdraw the registration of a security" if after notice and opportunity for hearing the Commission finds that "the issuer of such security has failed to comply with any provision of this title or of the rules and regulations thereunder."

Existing Section 19(a)(2) of the Act, by its terms, currently gives the Commission the same authority with respect to suspending or withdrawing the registration of any security. It contains almost precisely the same language as the proposed amendment with the exception that the latter would condition this authority on a finding that the action is necessary or appropriate "in the public interest, for the protection of investors, or to carry out the purposes of this title." Section 9 of the bill thus would transfer the grant of authority from Section 19(a) to Section 12(j) of the Act.

We are somewhat uncertain as to the full range of implications which flow from the power to suspend or withdraw registration of a security under Section 12 of the Act. The present statutory pattern, whereby a system of periodic reporting and disclosure is required in respect of all issuers and securities meeting certain requirements, relies on the requirement of registration to bring these reporting requirements into play. For this reason, it seems almost anomalous, at least in the case of over-the-counter securities, to utilize suspension or withdrawal of registration as a sanction, since it is the act of registration itself which subjects an issuer to the various disclosure requirements of the Act. It is true that various privileges currently attach to registration under Section 12 of the Act, such as the right to sell securities under Rule 144 (although this right is of benefit to insiders and other stockholders rather than issuers per se), the right to use certain shortened registration forms under the Securities Act of 1933 and eligibility for trading in the NASDAQ system. Moreover, it is conceivable that if steps are taken to integrate the disclosure schemes of the Securities Act with that of the Securities Exchange Act, this authority may become a more useful tool for the Commission to employ. At the present time, however, we believe our authority summarily to suspend trading under Section 15(c)(5) of the Act and Rule 15c2-11 provide ample authority for us to regulate over-the-counter trading in appropriate cases.

Section 10. Section 10 of the bill would amend various provisions of Section 15 of the Act, specifically paragraph (1) of subsections (a), paragraphs (8) and (10) of subsection (b) and paragraphs (1) and (2) of subsection (c). The amendment is identical in all cases: substitution of the phrase "otherwise than on a national securities exchange of which it is a member" for the present phrase "otherwise than on a national securities exchange." These paragraphs currently apply to a broker or dealer who trades other than on a national securities exchange (in other words, in the over-the-counter market); as amended, they would apply not only to brokers or dealers who transact business on exchanges of which they are not members. These changes recognize that many brokers and dealers can utilize exchange facilities without incurring the full obligation of membership.

The Commission approves of these changes.

Section 11. Section 11 of the bill would add new Section 15(c)(6) to the Act, which would provide for Commission regulation of dealers who hold themselves out as market makers (presumable non-specialists) and would authorize the Commission to require disclosure of limit orders left with such dealers.

The apparent purpose of proposed Section 15(a)(6) is to give the Commission pervasive direct authority to regulate the activities of all market makers. Such regulation could include, among other things, rules with respect to priority, parity and preference for various kinds of orders, a system of registration for those market makers wishing to utilize a composite quotation system, including establishment of qualifications and responsibilities for such market makers, and other related matters. We believe this kind of authority is important to clarify the Commission power to adopt many of the fundamental rules which will govern the new national market system.

As described in the Commission's comments on Section 6 of the bill, proposed Section 15(c)(6) also would assist in assuring priority of public orders by authorizing the Commission to require market makers to disclose any limit orders held by them to such persons, and in such manner, as the Commission may designate.

The Commission supports this section.

Section 12. Section 12 of the bill would amend Section 15A(a) of the Act to provide a new system (including revised procedures and standards) for registration with the Commission of a national securities association. The revisions make the standards and procedures for registration of a national securities associations parallel to the standards and procedures for registration of national securities exchanges provided in Section 5 of the bill. The Commission's comments with respect to Section 5 are equally applicable with respect to Section 12 of the bill.

Section 13. Section 13 of the bill would amend Section 15A(b) of the Act to establish the same procedures and standards for adoption of rules by a national securities association as would apply to exchange under Section 5 of the bill amending Section 6 of the Act. Section 13 would amend paragraphs (2), (7), (9) and (10) of Section 15A(b) of the Act to correspond with paragraphs (3), (4), (5) and (6) of proposed Section 6(b) of the Act, respectively. (Some differences between corresponding paragraphs do exist and are covered by our comments on Section 5 of the bill.) Proposed paragraph (8) of Section 15A(b) would retain the existing provision which prohibits a national securities association from imposing any schedule of prices, fixed minimum rates of commission or other charges. The Commission's comments with respect to Section 5 are equally applicable with respect to Section 13 of the bill.

Section 14. Section 14 of the bill would amend Section 15A(e) of the Act to parallel the amendments which Section 5 of the bill would make to Section 6(c) of the Act. Section 14 would prescribe new statutory limits upon the time within which the Commission would be required to grant the registration of a national securities association or to take appropriate administrative action to determine whether such an exchange's application should be denied. The Commission's comments with respect to Section 5 of the bill, discussing proposed Section 6(c) of the Act, are application to Section 14.

Section 15. Section 15 of the bill would amend Section 15A of the Act by deleting subsections (g), (h), (j), (k), (l) and (n) and relettering the subsections (i) and (m) as new subsections (g) and (h). Existing subsections (i) (which would be retained and relettered as subsection (g) by the bill) permits registered securities associations to prohibit their members from dealing with non-members except on the same terms on which they deal with the general public. Subsection (n) (which the bill would delete) was included in the 1938 amendments to the Act specifically to prevent a conflict between subsection (i) and the antitrust laws. To retain subsection (i) and delete subsection (n), in the Commission's opinion, might subject national securities associations to attack under the antitrust laws where their rules do nothing more than take advantage of the lawful provisions of subsection (i). Subsection (i) could become a meaningless provision which associations justifiably would be hesitant to use. The Commission thus suggests that subsection (n) be retained.

The other subsections which would be deleted from Section 15A of the Act would be incorporated by Section 18 of the bill into Section 19 of the Act. The Commission's comments on Section 18 of the bill are applicable to such subsections.

Section 16. Section 16 of the bill would amend Section 17(a) of the Act to subject securities information processors to the reporting requirements of that section. It would also clarify the obligation of all parties subject to the reporting requirements of Section 17(a) to furnish copies on request of any memoranda, reports or other records which the Commission may require them to maintain, and it would make all memoranda, reports, records and other materials of such parties, not just those which Commission rules require to be kept, subject to such examinations by representatives of the Commission as may be deemed necessary by the Commission in public interest or for the protection of investors.

The Commission is in full accord with the inclusion of securities information processors under the reporting requirements of Section 17(a). The operations of securities information processors are becoming increasingly vital to the trading mechanism, and it is critical that the Commission's regulatory authority with respect to them be as complete as it is in the case of other regulated entities. For example, it surely will be important for the Commission, in performing its surveillance function, to be able to reconstruct

market conditions, such as existing bids and offers, at any point in time. Once comprehensive reporting of quotation and transaction information exists, it will be possible to do so, assuming ample authority.

The Commission also supports the provision of proposed Section 17(a) requiring reporting parties to furnish copies of required documents at Commission request. In the past, there has been great reluctance on the part of exchanges to provide copies of confidential membership data without receipt of a subpoena, based on the advice of counsel as to possible exchange liability for misuse of the material. Although we believe that the Commission already has the power to require production of such materials under Section 17(a) of the current statute (and plans to adopt proposed Rule 17a-1 on this subject shortly), the proposed language would provide a helpful clarification.

The Commission also approves of the proposed extension of its present authority under Section 17(a) to examine all business records kept by reporting parties. Such authority would bar the withholding by reporting parties of non-required data which might be of assistance to the Commission in the exercise of its regulatory functions.

Section 17. Section 17 of the bill would add a new Section 17(c) to the Act which would authorize the Commission to allocate regulatory responsibilities among self-regulatory organizations in respect of persons who are members of more than one such organization. A certain degree of overlap currently exists in this regard among the exchanges and the NASD.

As noted, we believe that the substance of subsection (h)(3) of proposed Section 11A should be included in proposed Section 17(c). This inclusion would more closely draw together provisions of the bill which are aimed at the elimination of duplicative procedures and regulatory conflicts and thereby establish a more efficient self-regulatory structure for the national market system.

It should be noted that Section 17(c) would override Section 9(c) of the Securities Investor Protection Act of 1970 ("SIPA"), which authorizes the Securities Investor Protection Corporation ("SIPC") to designate a self-regulatory organization to examine SIPC members which are members of more than one self-regulatory organization for compliance with applicable financial responsibility rules. We believe it is preferable for the Commission to have this authority, particularly since the scope of the term "financial responsibility rules" may not be suspectible [sic] of precise delineation. It may be desirable, however, also to provide for consultation by the Commission with SIPC in the allocation of examinations relating to financial responsibility and to effect appropriate amendments to Section 9(c) of the SIPA.

Section 18. Section 18 of the bill would amend Section 19 of the Securities Exchange Act as follows. Paragraph (1) of Section 19(a) would be revised to set forth the Commission's authority to sanction self-regulatory organization, which is now contained in Sections 15A(1)(1) and 19(a)(1) of the Act. Sanctions could be imposed not only for violation of the Act and the rules and regulations thereunder but also for failure by the organization to enforce its own rules. In addition to the sanctions of suspension or withdrawal of registration, which already provided for, the bill would permit the censure of, or limitation of the activities, functions and operations of, such organizations. To impose any sanction, the Commission would have to act by order following a hearing on the record. The increased flexibility in sanctions is a welcome change, and the addition of failure to enforce compliance with the self-regulator's rules as a grounds for disciplinary action by the Commission is helpful.

Paragraphs (2) and (3) of Section 19(a) would be revised to make the Commission's authority with respect to the disciplining of exchange members (i.e., suspending or expelling them from membership) and exchange officers (i.e., removing them from office) consistent with its existing authority in Section 15A (1)(2) and (3) of the Act with respect to the disciplining of association members and officers. In addition, the sanction of censure would be added in the case of officers of self-regulatory organizations. We do not object to these changes, as far as they go. We would suggest, however, that in addition to the grounds for suspension or expulsion of a member of a self-regulatory organization set forth in proposed Sections 19(a)(2)(A) and (B), the Commission be authorized to suspend, bar, or expel, after notice and opportunity for hearing, any member that it finds has willfully aided, abetted, counseled, commanded, induced or procured the violation by any other person of any provision of the Act or the Securities Act and the rules promulgated thereunder.

Our principal criticism of the changes if that they do not give the Commission the power to enforce a self-regulatory body's rules directly. The Commission, in its Study of Unsafe and Unsound Practices of Brokers and Dealers, 6/ cited its need for authority to enforce the rules of self-regulatory organizations. A bill – H.R. 15303 – which would have given us such authority, was drafted by the Commission and introduced during the last session.

6/ Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess., at 7 (1971).

of Congress. Essentially, our authority to enforce exchange rules under H.R. 15303 would not have extended to those rules concerned solely with internal management or procedures between a self-regulatory organization and its members which do not substantially affect the public interest or investors. In addition, under H.R. 15303, we would not have been empowered to enforce a self-regulatory organization's rules without first notifying the organization of the alleged violation and the Commission's intention to institute a proceeding, in order to give it a reasonable time in which to compel compliance with its own rules. We believe this approach is entirely consistent with the concept of self-regulation. To implement it, we recommend the inclusion of the following on line 9 of page 30 of the bill, following the word "thereunder:"

> or has violated a rule of such organization (except a rule concerned solely with internal management or procedures as between a self-regulatory organization and its members which does not substantially affect the public interest or the interests of investors).

We also suggest that the following language be added at the end of line 13 on page 30:

> provided, however, that the Commission shall not proceed against any such member or person under this paragraph solely because of violation of any self-regulatory organization's rule without first notifying such organization of the alleged violation and the Commission's intention to institute a proceeding based on it and giving such organization a reasonable time in which to compel compliance with its rule.

Section 18 of the bill would also amend Section 19(b) of the Act, among other things, to authorize the Commission, by rule, to abrogate, alter or supplement the rules of any self-regulatory organization 7/ if the Commission deems such action to be necessary or appropriate in the public interest, for the protection of investors, to insure fair and orderly dealing in securities, to remove burdensome competition not reasonably necessary to the achievement of the purposes of the Act or to remove impediments to and perfect the mechanism of a national market system. The section also specifies procedures to be followed by the Commission in exercising this authority.

We consider the authority granted by the Commission in this section to be essential if the Commission is to carry out effectively the other responsibilities given to it by the bill.

7/ The term self-regulatory organization is defined in proposed Section 3(a)(23) to include any national securities exchange or registered securities association.

In order for the Commission to abrogate, alter or supplement the rules of self-regulatory organizations pursuant to proposed Section 19(b), it would be required to: (1) publish notice of its proposed rule in the Federal Register together with a full statement of its reasons for making the proposal and an evaluation of the effect of the proposed rule on the procedures and operations of the self0regulatory organization and the securities markets; (2) give interested persons an opportunity for the oral expression of views in addition to written submissions with respect to the proposed rule and any submissions made by the Commission; (3) present orally or in writing before the end of the comment period such facts and evidence upon which it intends to rely in promulgating the rule; and (4) publish with any rule adopted a full statement of the reason for such adoption and the facts and evidence in support thereof and an evaluation of the principal arguments presented against such adoption.

In our view, rulemaking by the Commission should be governed by the procedures specified in the APA which are applicable to all other administrative agencies. These procedures provide generally for public notice of proposed rulemaking and opportunity for interested persons to participate through submission of written data, views or arguments and in some cases oral presentations. There does not appear to be any reason, either in law or policy, why these procedures, coupled with the requirement that the Commission set forth the basis and purpose for any rule it adopts, do not afford interested persons a full opportunity to make known their views and a basis upon which judicial review of the Commission's rule might be sought.

We strongly object to the imposition of adjudicatory-type procedures on policymaking activities of the Commission. The procedures proposed could hamper effective Commission oversight of industry self-regulation, and would run counter to the recommendations of the Administrative Conference 8/ and recent judicial decisions of 9/ recognizing the propriety and utility of rulemaking procedures for policymaking endeavors.

In addition to the above information, proposed Section 19(b) would require the Commission to publish an evaluation of the principal arguments presented against a particular proposed rule. This provision does not set forth any criteria by which the Commission is to determine which of the arguments against a proposed rule are to be considered principal arguments. At a minimum, we believe that the Commission should be allowed the flexibility to determine whether and to what extent it is necessary to rebut particular arguments when stating its reasons for adopting a particular rule.

8/ Administrative Conference of the United States, Recommendation No. 72-5 (Dec. 14, 1972).

9/ See Florida East Coast Ry. V. United States, 410 U.S. 224 (1973); United States v. Allegheny-Ludlum Steel Corp., 406 U.S. 742 (1972); PBW Stock Exchange, Inc., et. al. v. Securities and Exchange Commission, Nos. 73-1116, 73-1165, 73-1266 and 73-1267, (C.A. 3, Sept. 28, 1973).

Section 18 also would add a new subsection (c) to Section 19. Proposed Section 19(c)(l) would require each self-regulatory organization to file, in accordance with such rules as the Commission may prescribe, copies of proposed rule changes accompanied by "a concise general statement" of the basis and purpose of the proposed change.

Proposed Section 19(c)(2) would require the Commission to publish notice of proposed changes in the rules of the self-regulatory organizations, provide interested persons with opportunity for comment on such proposed rule changes and make available for public inspection copies of any correspondence between the Commission and interested persons regarding such proposed rule changes. Providing such an opportunity for public notice and comment generally is desirable and we have endeavored to accomplish this salutary goal where appropriate. We believe, however, that a self-regulatory organization, rather than the Commission, should solicit public comment on proposed rule and policy changes, so that the organization may have the benefit of such comment before it acts. We also believe that solicitation of public comment need not be required with regard to all rule changes. For example, housekeeping rules and other minor or technical changes should be excepted from this procedure. Where a securities exchange or association has obtained public comment, the Commission should not be required to duplicate that effort unless, in its discretion, it deems correspondence relating to proposed rule changes be made public, is too broad. We believe the Commission should have the discretion to withhold from public inspection any correspondence not now available to the public under the Freedom of Information Act.

The provision also would require the Commission, within 21 says of the filing, or up to 60 days if it finds such period to be appropriate, either to publish a "rule" approving and declaring effective the proposed rule change, if the Commission finds it not inconsistent with the registration requirements for such organization or with the purposes of the Act and not otherwise inconsistent with public interest, or to institute further proceedings, giving interested persons an opportunity for oral presentation of their views, to determine whether the proposed change should be disapproved. We believe that the minimum 21-day period in which the Commission must act with regard to a proposed rule change or publish reasons for requiring a longer period is too short a period for the Commission to complete its analysis and review of many of the more complex proposed rule changes.

We assume the requirement that the Commission act by rule to approve and declare effective proposed changes in the rules of self-regulatory organizations is not intended to convert the rules

of such organizations into Commission rules, particularly for enforcement of purposes. For example, we assume that a member's violations of a self-regulatory organization's rule approved pursuant to this provision would not subject him to the penalties provided in Section 32(a) of the Act. If, as it appears to us, the purpose of this provision is to permit judicial review of self-regulatory organization rules in the same manner as Commission rules, we concur in this objective.

Subparagraph (A) of Section 19(c)(2) would require that the Commission approve each rule change and publish a rule approving and declaring it effective. We would prefer the approach of Section 15A(j) of the present statute, which provides, with regard to proposed rule changes of national securities associations, that they shall become effective if not disapproved by the Commission within 30 days of filing. Because a proposed change in the rules of a self-regulatory organization either may be the minimum improvement which the Commission finds acceptable or may represent a change which the Commission would not necessarily favor but finds it is not inconsistent with the Act, we may wish to permit the rule change without giving it a stamp of Commission approval.

Subparagraph (B) of proposed Section 19(c)(2) of the Act would require opportunity for oral presentation during proceedings to determine whether a proposed rule change should be disapproved. In the past, the termination of whether interested persons should be afforded an opportunity for oral presentation of their views in quasi-legislative matters has been left to the discretion of the Commission. For purposes of efficient and expeditious determination of whether to disapprove proposed minor rule changes, we believe the Commission should retain its present discretion in such matters.

Proposed Section 19(c)(3) of the Act would permit the Commission to accelerate the effectiveness of proposed changes in the rules of the self-regulatory organizations if not inconsistent with the purposes of Section 19(c). We believe such a provision is desirable, and we assume that in such cases the public comment procedures mandated by Section 19(c)(2) could be waived.

Proposed section 19(d) of the Act would provide that whenever a self-regulatory organization takes any final disciplinary action, or denies admission to membership, or prohibits or limits any customer or issuer with respect to requested access to services offered by such organization or its members, the organization shall file with the Commission such notice as the Commission, by rule, may prescribe. With regard to the language "any customer

or issuer," see our comments on proposed Section 6(b)(6) of the Act. Furthermore, to provide the Commission with a standard upon which to base any rules it may prescribe regarding the information to be filed pursuant to this subsection, we recommend the addition of the language "as necessary or appropriate in the public interest or for the protection of investors" between the words "prescribe" and "and" in line 14 one page 35 of the bill.

Subsection (d) also would provide that any final disciplinary action, denial of admission, or prohibition or limitation of access to services by a self-regulatory organization shall be subject to review by the Commission. Under this provision, application to the Commission for review, or institution of review by the Commission on its own motion, would not operate as a stay of the self-regulatory organization's actions, unless the Commission otherwise orders. Insofar as this provision applies to disciplinary action of national securities associations, it would change existing law (See Sec. 15A(g)).

At the present time, appeal to the Commission from an NASD disciplinary action brings about an automatic stay of the sanction pending review (except where the Commission otherwise orders pursuant to a shortened procedure for vacating the stay upon application by the NASD). Under the current provisions of the Act and Commission rules, it has been our position that there is no automatic stay from NASD denials of membership or services (See Sec. 15A(g), 10/ and Rules 15Aj-2 and 15Aj-3). Since there is no specific statutory procedure for direct Commission review of these three types of actions when taken by exchanges, there are, of course, no stay provisions as of this time. Except as noted below, we see no basis for questioning the bill's maintenance of the status quo respecting status in the bases of denials of membership and denials of services.

Disciplinary action stays present a different, and more difficult, question. In general, the staff has, in the past, favored a provision such as that contained in S. 2519 respecting stays of disciplinary actions pending Commission review. It can be argued that in a serious case of an expulsion or bar based, for example, on fraud, the public interest would normally require that the penalties go into effect as rapidly as possible and that in such situations the burden should be shifted to the respondents to establish that their continuation in business would be appropriate. This would also afford the action of the self-regulator a kind of resumption of regularity, generally considered appropriate

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10/ Sec. 15A(g)'s provision for an automatic stay can be read as applying to both disciplinary and denial actions. However, if so read, it is not clear what a "stay" in the case of a denial of admission would mean -- i.e., does the NASD have to admit an applicant pending review? We have not interpreted the stay provision to apply to such denials.

in similar situations (e.g., Commission broker-dealer proceedings) where there has already been a hearing.

Generally speaking, however, the existing automatic stay provision has no presented serious difficulties in the case of the NASD, and we can recall only one instance in which the NASD even considered applying for vacation of the stay. In most of the expulsion cases appealed, the first has been out of business by the time the case reached the Commission – because of financial failure or the fact that the Commission had at some interim stage obtained an injunction, the terms of which the firm could not comply with. 11/ In addition, in cases where the penalty is less than expulsion (e.g., suspension or fine) there is generally no compelling public interest in putting the sanction into effect immediately, particularly since the sanction itself implies that the firm or individual can remain in or should be able to return to business at some stage. In suspension situations, moreover, the penalty (or a substantial part of the penalty) would have been served, but for the automatic stay, by the time the Commission acted on review. This could be unfair. For these reasons, we would not be inclined to urge a change in the automatic stay provisions respecting associations or a different approach on the subject for exchanges.

While at the present time there is no provision for an automatic stay pending Commission review of NASD denials of services (e.g., under Rules 15Aj-2 and 15Aj-3) there could be denial situations in which we might well take the position that the automatic stay provisions of Section 15A(g) of the Act apply. This could occur where the nature of the action taken by the NASD in a particular case involved what was, in essence, a disciplinary action. For example, the NASD could, under its rules relating to the operations of NASDAQ and the National Clearing Corporation, withdraw services as a result of a member user's violation of the NASD's rules of fair practice. Stated another way, if an existing user is denied service because of his misconduct, as opposed to a mere failure to meet continuing qualifications standards (e.g., a failure to pay fees or other monies due, to maintain the requisite minimum capital or to furnish required reports) where fair practice standards violations are not alleged, the statute would appear to require the NASD action to be treated as a disciplinary action for all purposes, including Commission review. As of this time, we have had no specific applications of this position, but there appears to be some basis for making distinctions along these lines where services are withdrawn from an existing user. On the other hand, we see no reason to extend the automatic stay where a prospective member user applies for and is denied service since the economic consequences for the firm would clearly be quite different.

11/ It might be noted here that even if stays in NASD cases were not automatic, there could still be a need for injunctive intervention by the Commission since an NASD suspension from membership doesn't necessarily terminate the firm's right to do all business.

To summarize our views on the stay provision of the bill:

(1) We favor the proposal as it relates to denials of membership and services, where the action of the self-regulatory organization is not in the nature of a disciplinary action based on an existing member's or user's violations of fair practice standards.

(2) We have some difficulty, based on our experience with NASD proceedings, in supporting this provision of the bill as it relates to ordinary disciplinary proceedings involving fair practice standards and other actions of self-regulatory organizations that appear to be of such a disciplinary character.

Accordingly, it may be appropriate to amend proposed Section 19(d) in line with the foregoing.

Proposed Section 19(e)(l)(A) would give the Commission authority, after appropriate review, to remand for further proceedings disciplinary actions by self-regulatory organizations against a member or person associated with a member. The Commission also could affirm the action upon review or modify the sanctions or penalties imposed. The Commission would not be given the authority to increase such sanctions or penalties. The need for Commission authority to review self-regulatory disciplinary proceedings on its own motion as well as on appeal, in order to achieve fair and equitable application of the rules of self-regulatory organizations, has been thoroughly documented by the Commission. If the Commission should determine that a sanction is inadequate or inappropriate it should be able to remand the disciplinary proceeding to the self-regulatory organization with instructions to reconsider the sanction or penalty to determine whether some different or additional penalty should be imposed. After such reconsideration, the Commission should be able again to review the action and impose whatever sanction it deems appropriate.

Proposed Section 19(e)(2) would authorize the Commission to cancel or reduce any disciplinary action taken by a self-regulatory organization if it finds that such disciplinary action is neither necessary nor appropriate or is excessive or oppressive. The Commission does not disagree with these standards. Proposed Section 19(e)(2), however, can be read to require that disciplinary action be set aside or modified also where such action is not reasonably necessary for the achievement of the purposes of the Act. As noted, we believe this standard to be inappropriate and recommend that it be deleted from this provision. In our view, the applicable standard, which is included in the Section as drafted, should be whether a particular action is necessary or appropriate within the scope and purposes of the Act.

Proposed Section 19(f) would set forth the standards by which the Commission would review self-regulatory disciplinary actions and prohibitions or limitations of a customer's or issuer's access to services offered by a self-regulatory organization or its members. If the Commission finds that the standards have been satisfied, it shall, by order, dismiss the proceeding; absent such a determination, the Commission, by order, shall set aside the self-regulatory organization's action and require it to admit the applicant to membership or permit it appropriate access to services. Reference is made to our comments on the proposed amendment to Section 6(b)(6).

Section 19. Section 19 of the bill would amend Section 21(f) of the Act, among other things, to empower the district courts of the United States, upon application by the Commission, to issue writs of mandamus or injunctions commanding a self-regulatory organization to enforce compliance by its members or persons associated with its members with the provisions of the Act, and the rules promulgated thereunder as well as the rules of the organization.

While the above provision would aid the Commission significantly in carrying out its oversight responsibilities, we would prefer that, in addition to the authority conferred in this section, the district courts be given the authority to issue a mandatory injunction upon application of the Commission, directly to a member of a self-regulatory organization or a person associated with such member, commanding them to comply with the rules of that organization.

Section 20. Section 20 of the bill would amend Section 23 of the Act which empowers the Commission and the Federal Reserve Board to promulgate such rules and regulations as may be necessary to execute the functions vested in them by the Act.

Proposed Section 23(a) would require the Commission, in making any rules and regulations pursuant to authority given it by the Act, to consider the impact any such rule would have on competition. Moreover, the Commission would be prohibited from adopting any rule which would impose a burden on competition unless such rule were found by the Commission to be reasonably necessary to carry out the purposes of the Act. The Commission would be required to include, in both its notices of any proposed rule in the statement published upon the adoption of the rule, a full explanation of its reasons for determining that the rule is reasonably necessary to carry out the purposes of the Act.

We recognize that in adopting rules the Commission may be obliged to consider the policies underlying the federal antitrust laws, where appropriate. An express requirement to this effect, however, appears unnecessary; in any event, if the Subcommittee intends to include such a standard, it should take the form we have suggested above (see p. 7).

The Commission does not object to the requirement that it state its reasons for determining that a rule which may place a burden on competition is reasonably unnecessary 12/ to achieve some regulatory purpose under the Act. It is our view, however, that the rules and other actions of the Commission are not to be judged solely by the standards of the antitrust laws but by those of the Securities Exchange Act; the Commission's action would be an exercise in futility if its rules were to be subjected to de novo review in an antitrust court applying antitrust standards alone. If the Commission determines that a particular rule reasonably achieves the purposes of the Act, even though it may impose some burden on competition, compliance with that rule by self-regulatory organizations and other persons should not be the subject of a plenary antitrust action. 13/ The Commission's rule in such cases should be subject to the judicial review only in a proceeding to review the rule itself in order to ensure that the determination was not arbitrary or capricious and that a factual predicate for the rule does exist.

The Commission urges the Subcommittee to make clear in this legislation that once the Commission has concluded that a particular rule reasonably achieves any of the objects and purposes of the Act, the validity of the rule is not to be determined in an antitrust court solely by the application of the standards of the antitrust laws.

Proposed Section 23(a) also would require the Commission to make available for public inspection copies of any correspondence between the Commission or its staff and any interested person concerning any proposed rule or regulation. Since it has been the Commission's normal practice to make such correspondence available for public inspection we have no objection to this provision.

Proposed Section 23(b)(1) would require the Commission to include in its annual reports to Congress a summary of its oversight activities with respect to self-regulatory organizations. Such a summary would include a description of any examination of a self-regulatory organization, any recommendation presented to such an organization with regard to its organization, character or rules and any action taken by the organization in response to any such Commission recommendation.

Insofar as the requirement concerning reporting of examinations of self-regulatory organizations is construed to require the

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12/ As noted, the Commission does not consider this to be the appropriate standard.

13/ This Subcommittee has reached a similar conclusion. Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess., Report of the Securities Industry Study, 239 (Comm. Print, 1973).

inclusion of the results of a particular examination of a particular self-regulatory organization, we would object to its inclusion in the bill. We believe that it is appropriate to indicate in our annual report the nature, operation and results of the Commission's inspection program. We do not believe, however, that the particular results of any given inspection should be required to be stated in an annual report. Such a requirement would be unduly burdensome and, in our view, unnecessary since the aggregate information relating to the Commission's program will be included.

Although the Commission's does not object to including in its annual report the recommendations made by it to self-regulatory organizations concerning their organization, character or rules and what action, if any, those organizations might have taken with respect to those recommendations, we do not believe that information recommendations made by the Commission's staff to a self-regulatory organization should be included. In our view, such a requirement may inhibit the informal consulting relationship which the self-regulatory organizations currently and appropriately have with the Commission's staff which has been recognized to be essential to effective regulation.14/

Proposed Section 23(b)(2) would require the Commission to include in its annual reports a statement and analysis of the expenses of each self-regulatory organization in carrying out its responsibilities under the Securities Exchange Act. We note in this regard that it has long been the Commission's practice, in reviewing the fees and assessments of the NASD to assure their "equitable and allocation" under Section 15A(b)(7), to obtain such analyses from the Association. This procedure has been essential for the proper execution of the Commission's oversight responsibilities in this area. On the other hand, we agree with the Subcommittee that the Commission "should not be placed in the position of a budget review board for the self-regulatory agencies . . .". 15/ With this caveat, we do not object to this requirement, provided the Commission is given clear authority to require the necessary data from the self-regulatory organizations and provided it receives the necessary appropriations for the staff which would be required to accumulate and analyze the additional data to be received.

14/ See, e.g., Attorney General's Committee on Administrative Procedure, Administrative Procedure in Government Agencies, S. Doc. No. 10, 77th Cong., 1st Sess. pt. 13, 102-106 (1941).

15/ Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess., Report to the Securities Industry Study, 191 (Comm. Print, 1973).

Proposed Section 23(b)(3) would require the Commission to include in its annual reports data and other information relating to the development of a national market system. It is the Commission's practice to include in its annual reports information concerning all new developments within the past fiscal year which would include information concerning a central or national market system. We have no objection to this requirement.

Proposed Section 23(b)(4) requires the Commission to include in its annual reports information concerning its handling and disposition of any petition filed with it for the issuance of a rule. It has been the Commission's policy, where appropriate, to announce publicly the tendency and the disposition of a petition for rulemaking. We have no objection to including such information in our annual reports, but since we can and do receive a wide variety of requests for rulemaking, few of which are noteworthy, we believe this requirement both burdensome and of doubtful utility.

Section 21. Section 21 of the bill would amend Section 25(b) of the Act to permit any person adversely affected by a rule promulgated by the Commission pursuant to proposed Section 19(b) to obtain review of that rule in an appropriate court of appeals. The section provides that the court "shall have jurisdiction to review the rule on the record of the rulemaking proceeding in accordance with . . . [the judicial review provisions of the APA]."

Pursuant to Section 10(e) of the APA, as codified, 5 U.S.C. 706(1)(E), a reviewing court shall set aside agency action (which includes a rule) that it finds to be unsupported by substantial evidence in a case reviewed on the record of an agency hearing provided by statute. Since proposed Section 19(b) requires an agency hearing, in a broad sense, and proposed Section 25(b) requires the court to review a rule promulgated pursuant to Section 19(b) on the record of the rulemaking proceeding, it could be argued that the Subcommittee intends that the standard of review of such rules will be substantial evidence.

The Commission does not believe that its rules, including those adopted pursuant to proposed Section 19(b), should be tested by a substantial evidence standard. In exercising its quasi-legislative authority to promulgate rules, the Commission often relies upon broad policy considerations rather than exclusively upon specific facts. These considerations are not "evidence" in the common sense of that word. Since rulemaking reflects agency policy determinations, Commission rules should be invalidated only where a reviewing court finds that the Commission's action was arbitrary, capricious or an abuse of discretion,

contrary to constitutional right, power, privilege or immunity, or in excess of its statutory jurisdiction or that the rule was adopted without observance of procedures required by law.

Proposed Section 25(b) also would give a petitioner the right to apply to the court of appeals for leave to adduce additional data, views or arguments. This provision is the same as that contained in existing Section 25(a) of the Act except that, under this latter section, either the petition or the Commission could move the court of appeals for leave to adduce additional data. Assuming court of appeals review of rules is nevertheless adopted, it is not clear why proposed Section 25(b) limits this right of adducing additional evidence to the petitioner, and we recommend that it be amended to authorize the Commission also to seek leave to adduce additional data, views and arguments.

Proposed Section 25(b) also specifies the materials that shall be considered to constitute the record for purposes of review. We have no objection to this provision.

Section 22. Section 22 of the bill would amend Section 25 of the Act to add Section 25(c). That Section would provide that the commencement of review proceedings under Section 25(a) of the Act or proposed Section 25(b) would not operate as a stay of the Commission's order or rule unless specifically ordered by the court. Again, assuming court of appeals review of rules, the Commission has no objection to proposed Section 25(c) since it merely would extend the provisions relating to stays presently contained in Section 25(b) of the Act to rules reviewable under proposed Section 25(b).

Section 23. Section 23 of the bill would delete paragraph (3) of Section 28(b) of the Act, which states that nothing in the Act is to be construed to modify existing law with regard to the binding effect of any disciplinary action taken by the authorities of an exchange on any member thereof as a result of violation of any rule of the exchange insofar as the action taken is not inconsistent with the Act or rules and regulations promulgated thereunder. The Commission does not object to deletion of paragraph (3).

Section 24. Section 24 of the bill would amend paragraphs (3) and (4) of Section 1(b) of the Act of August 20, 1962 (15 U.S.C. 78d-1(b)) to provide that a person who is adversely affected in certain areas by actions of the staff, acting pursuant to delegated authority from the Commission, is entitled to review of the

staff's action by the Commission. Staff action that is reviewable includes suspension or withdrawal of the registration of, or the censure or imposition of any limits on, a self-regulatory organization, or the suspension or expulsion of a member of such organization, or the suspension or barring of any person from being associated with any member of such organization or the removal from office of any officer or director of any such organization. Also reviewable by the Commission is staff action that suspends trading in a security on an exchange pursuant to Section 19(a) of the Act.

The Commission, while generally agreeing with this proposed section, believes that the phrase "impose any limitation upon the activities . . . of a self-regulatory organization" is broad and should be clarified either in the bill or in its legislative history since almost any action taken with respect to such an organization arguably may be deemed to limit its activities. The Commission also believes that the denial of registration by the staff should be subject to review by the Commission and feels this should be included in proposed paragraph (3). It should be noted that this provision is included in the present paragraph (3).

Section 25. Section 25 of the bill would provide that the bill will become effective on the date of its enactment, except that amended Sections 6(b), 11A and 15(A)(b) of the Act would become effective 180 days after the date of enactment, at which time the Commission would be required to suspend the registration of, or impose appropriate limitations on, any registered exchange or association if it finds, after a hearing, that such organization does not comply with the requirements of those sections. Any suspension or limitation would remain in effect until the Commission issued an order declaring that such organization confirms to such requirements. In light of the mandatory nature of such action by the Commission, we recommend that the Commission be expressly authorized, upon a showing of good cause by the self-regulatory organization, to grant one extension of not more than 30 days in order to prevent undue hardship as a consequence of its non-willful failure to amend its rules within the time allotted.

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[stamp] SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Division of
Market Regulation

Mr. Harvey A. Rowen, Special Counsel
Subcommittee on Commerce and Finance
Committee on Interstate and Foreign Commerce
U.S. House of Representatives
Room 2125
Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Rowen:

This is in response to your letter of July 11, 1973 in which you requested the Commission's comments on legislation to amend Section 12(f) of the Securities Exchange Act of 1934 proposed by the National Stock Exchange in a letter to the Commission dated March 13, 1973 (the "National Proposal", a copy of which is enclosed herewith) and presented to the Subcommittee on Commerce and Finance of the House of Representatives' Committee on Interstate and Foreign Commerce on June 13, 1973. The proposed amendment to Section 12(f), which would add a new paragraph (1)(C), is as follows:

> "(C) Upon application of [sic] and approval by the Commission, an exchange may extend unlisted trading privileges to any security whose characteristics substantially meet the exchange's listing requirements and reporting requirements."

History of Unlisted Trading

As you know, as part of the 1964 amendments to the Securities Exchange Act, Section 12(g) extended the registration requirements of Section 12(b) and the disclosure requirements of Sections 13 and 14 to all issuers of unlisted securities which meet certain asset and securities distribution criteria. Accompanying this change, clause 3 of old Section 12(f) of the Act, pertaining to the extension of unlisted trading privileges to securities whose issuers voluntarily made disclosure equivalent to that required of listed issuers, was eliminated at the request of the Commission. The

Securities Industry Study, Report of the Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, dated February 1, 1973 (the "Senate Report"), notes that since new Section 12(g) would have made many unlisted issuers eligible for unlisted trading privileges under old Section 12(f)3, the National Association of Securities Dealers, Inc. viewed the 1964 amendments as a threat to the over-the-counter market. The Senate Report also states that the Commission's legislative proposals to implement its 1963 Report of the Special Study of Securities Markets (the "Special Study") included the repeal of old Section 12(f)3 on the basis that its "repeal . . . will assure a desirable conformance by issuers with the listing requirements of an exchange as a prerequisite to enjoying the privileges of trading on that or other exchanges." (Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 1642, 88th Cong., 1st Sess., at page 59 (1963).) According to the Senate Report, "no opposition was offered to the repeat of Section 12(f)3." Senate Report at pages 131, 132.)

The National Proposal

National argues that because the Securities Exchange Act affords equal protections to investors with respect to both listed and unlisted securities, no fundamental reason exists for barring exchanges from admitting unlisted securities to exchange trading privileges. In addition, National believes that it is inequitable and not in the best interests of the securities markets for an exchange to be prevented from engaging in specialist activity in the securities of an issuer unless that issuer has been induced to list with an exchange while an over-the-counter market maker is not required to obtain any measure of issuer cooperation as a precondition to its market making activity. In National's view, the proposed amendment would shift the decision as to where trading in a particular security shall take place from the issuer to the market maker and, ultimately, to the investor. This shift, National urges, would help the investor by stimulating competition between market makers and by encouraging improvement of both exchange and non-exchange markets for any security whose characteristics conform to the requirements of both.

The amendment would allow an exchange to grant unlisted trading privileges to any security "substantially" meeting its listing and reporting requirements, regardless of whether the security is

registered under Section 12(g) of the Act. Since the equal disclosure provisions of Section 12(g) are the major rationale for the National Proposal, it appears to the Commission that, at the least, registration under that section should be a prerequisite to the extension of unlisted trading privileges to any security.

Economic Impact on Exchanges

National believes that because its prestige would be enhanced if it were permitted to trade securities of selected companies on an unlisted basis, additional issuers would be encouraged to list with National. The amendment, however, might produce other, less desirable economic effects, particularly if the extension of unlisted trading privileges were to become the practice of many exchanges. For instance, while the American Stock Exchange does impose a continuing listing fee on unlisted issuers admitted to trading, National does not intend to collect either an initial or continuing annual fee from issuers to which it extends unlisting trading privileges. Since such fees can be substantial, the failure to charge and collect them might induce a number of listed companies presently paying exchange fees to delist and make themselves available only for unlisted trading. Listing fees, initial and continuing, constitute an important source of exchange revenue. For example, such fees amounted to approximately 20% of the New York Stock Exchange's 1972 gross income, according to its 1972 Annual Report. If a significant amount of "fee-free" unlisted trading should result from adoption of the National Proposal, increased administrative costs would be experienced by the various exchanges without any assurance of a corresponding increase in revenue. The question of who should bear these costs (in the event an issuer admitted to the unlisted trading refuses or is not requested to do so) is unresolved. Perhaps such expenses should be borne by the entire exchange membership. On the other hand, the imposition of an additional transaction fee on brokers using exchange facilities for trades in unlisted securities might be an equitable solution.

Effects on Competition

In its discussion of the differing mechanics and capabilities of exchange specialists and over-the-counter market makers, National asserts that investor freedom to choose one or the other for execution of a trade would increase the pressure for improvement in both systems. However, the proposal could have exactly the opposite effect.

By increasing the number of issues available for trading on exchanges the amendment could accentuate the anti-competitive effects of exchange "off-board" trading rules, such as National's Rule 3-13.01 (a copy of which is attached to the National Proposal as Appendix No. 1). Virtually all exchanges have such a rule, and most such rules would severely restrict the ability of an exchange member to affect transactions either as principal or agent in unlisted securities admitted to trading, as they presently do with respect to listed securities, away from the exchange. Such rules, coupled with stock allocation procedures in effect on all exchanges, would make it difficult (if not impossible) for a member of an exchange which had acted as an over-the-counter market maker for a security admitted to unlisted trading privileges to continue that activity either on or off the exchange. Thus, trading by over-the-counter market makers in a security admitted to unlisted exchange trading privileges could be reduced significantly, leading to a concentration of trading in that security in a single exchange specialist, not by virtue of competitive forces, but because of exchange imposed strictures on member trading.

It is difficult to see why the Congress should help exchanges to increase their ability to compete with the over-the-counter market for trading in over-the-counter stocks (if, indeed, the question is not really one of competition between specialists and over-the-counter market makers) while exchange rules limiting off-board trading by members are permitted. Off-board trading rules restrict the ability of the over-the-counter market to compete with exchanges for trading in listed stocks (as the "third market"), both because members are restricted in their ability to make markets in listed stocks away from the exchange and because members are inhibited by exchange rules in their dealings with non-member market makers in such stocks.

Rights of Issuers

There is some disagreement as to how much of a voice an issuer should have in determining whether unlisted trading privileges should be extended to its securities. In the context of its consideration of the New York Stock Exchange's opposition to the inclusion of multiple market makers in a future central market system, the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, in the Senate Report at page 121, concluded that limiting trading in an issuer's securities to a single market "is not a prerogative of corporate management, which has no legitimate interest in restricting the trading opportunities of investors who have acquired a company's shares." The Special Study, Vol. 2 at page 836, however, states:

Consequently, consideration should be given to whether withdrawal of unlisted trading privileges (at least in the case of issuers not listed elsewhere) should be permitted only under specified circumstances, such as failure to meet the minimum exchange standards for retention of listed companies.

Investors should be entitled to expect that the securities of any issuer traded on an exchange, whether listed or not, are governed by exchange rules, such as those which require that a listed issuer promptly notify the exchange of the occurrence of certain events affecting the issuer, impose duties with regard to the distribution of interim financial statements to stockholders, require stockholder approval of the issuance of additional shares exceeding 20% of the amount then outstanding, and prohibits certain transactions between the issuer and its management. Compliance with exchange rules by an issuer is encouraged by the fact that publicity concerning violations and the possibility of delisting stigmatizes the issuer in the eyes of the investment community. It is an open question whether such a stigma would, or should, attach where unlisted trading privileges are imposed on an issuer without the issuer's consent and, perhaps, against its wishes. Exchanges may encounter difficulties in maintaining surveillance over uncooperative issuers admitted to unlisted trading. At the same time it appears that an exchange should be required to terminate an issuer's unlimited trading privileges if exchange rules are disobeyed. The potential for investor confusion under these circumstances is obvious.

Other Observations on Unlisted Trading

The Senate Report, at page 135, seems to favor expanding unlisted trading privileges, but only in the context of "implementation of the combined auction-dealer market enlisted securities." While acknowledging the benefits of permitting securities to be traded in both exchange and non-exchange markets, the Senate Report, at page 133, appears to acknowledge that existing market structure anomalies, such as exchange "off-board" trading rules, could promote undesirable disruption of normal trading patterns (e.g., by diminishing rather than increasing market making capacity) if unlisted trading and over-the-counter stocks were permitted at this time. In a central market system, however, where exchange members and non-members could deal on a more equal basis in any security, the view is expressed that competition would be enhanced by the extension of unlisted trading privileges.

Conclusion

Although open access to trading in securities by all qualified market makers is a goal of a central market system, we believe the proposal of the National Stock Exchange, considered alone, to be premature in view of the present structure of the securities markets. While the problems indicated above all seem capable of solution, it appears preferable for them to be addressed in the context of implementation of the central market system. Consequently, the Commission would support the proposed amendment only as part of legislation which (i) generally augments its authority to develop and implement a central market system, and (ii) specifically reserves to the Commission authority to disapprove applications for unlisted trading in a security unless it concludes, after consideration of such matters as the retention of "off-board" trading rules by the exchange making the application, that such trading would be in the public interest in view of the nature of the market for that security.

If you have any further questions concerning the National Proposal, please do not hesitate to contact us.

Sincerely,

Lee A. Pickard
Director