43rd Annual Report of the SEC

for the fiscal year ended September 30, 1977

and

the transition quarter-
July 1, 1976-September 30, 1976

SECURITIES AND EXCHANGE COMMISSION

Headquarters Office
500 North Capitol Street
Washington, D.C. 20549

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PHILIP A. LOOMIS, JR.
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CHAIRMAN'S LETTER OF TRANSMITTAL

The Honorable Walter F. Mondale
President, U.S. Senate
Washington, D.C. 20510

The Honorable Thomas P. O'Neill, Jr.
Speaker, U.S. House of Representatives
Washington, D.C. 20515

Gentlemen:

I am pleased to transmit to Congress the *Annual Report of the United States Securities and Exchange Commission* for the period July 1, 1976, to September 30, 1977. Those 15 months were a time of virtually unprecedented activity and accomplishment for the Commission, and the *Annual Report* reflects that fact. Our report is comprehensive and detailed and will, I am confident, be an important aid to Congress in understanding the Commission's work.

The latter half of the period treated in this report coincided with the first several months of my term as Chairman of the Commission. For that reason, although the report itself is essentially a record of past achievements, I believe its transmittal affords a valuable opportunity for me to offer my perspective on the future. Accordingly, I have outlined briefly below some of the major issues which I expect the Commission will be addressing during the balance of my term as Chairman.

Investor Confidence and Capital Formation. Congress's fundamental objective in enacting the federal securities laws was to promote public confidence in the securities markets in order to foster the vital process by which the capital is marshalled from the public and channelled into growth of our economy. Accordingly, while the Commission's primary responsibility is to protect investors, the discharge of that responsibility results, in a broad sense, in stimulation of investors' willingness to provide the new capital necessary to fuel our private enterprise system. The interrelationship between investor confidence and capital formation has several important consequences.

First, the Commission must be sensitive to the effects of its

activities on the capital formation process and must ensure that Commission regulation under the federal securities laws does not inadvertantly impair capital formation. In that vein, for example, the Commission recently announced a broad-scale re-examination of the impact of its regulations on small businesses with an eye toward easing that burden whenever possible, consistent with the Commission's statutory responsibility. Similarly, we will strive to be alert to other facets of the economic consequences of our regulatory actions.

Second, the Commission also has a responsibility to understand the forces that might distort or impair the efficiency with which the market allocates capital to competing investment opportunities. Whether those forces are directly under the Commission's jurisdiction or arise in other areas—such as the federal tax system–the Commission's familiarity with the dynamics of the securities markets obligates us to analyze their impact. The Commission's views on these matters can be of assistance to Congress and to other arms of the federal government whose activities impact on capital formation.

Third, although the Commission is not charged with maintaining the economic health of the securities industry, we have an obvious responsibility to understand the industry's economic condition and to endeavor to ensure that the Commission's discharge of its regulatory responsibilities is not inconsistent with a financially strong and stable industry. If the securities business were to become unprofitable and unable to attract talent and capital, the injurious consequences would be felt in every segment of the American economy.

Finally, the Commission's role in fostering efficient capital formation turns on the effective utilization of its statutory powers in order to assure the public confidence necessary for healthy securities markets. Several components of that role are treated below.

Development of the National Market System. The first requisite to public confidence is fair, efficient, and orderly securities markets. In that connection, Congress, in the Securities Acts Amendments 1975, directed that the Commission facilitate the development of a national market system for securities. The national market system, when fully implemented, will tie together a network of highly diverse and complex individual market centers and will represent the most significant restructuring of the United States securities markets ever undertaken. During the next several years, the Commission will complete the task, already well under way, of putting the components of that system into place. Our philosophy has been to move deliberately, in order to insure that the consequences of the Commission's actions are those we anticipate and that the end product is consistent with the objectives of the 1975 Amendments.

The Securities Exchange Act, as amended, characterizes the securities markets as "an important national asset which must be preserved and strengthened" and spells out Congress's goals in broad terms. For example, Subsection 11A(a) states:

"The linking of all markets for qualified securities through

> communications and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investor orders, and contribute the best execution of such orders."

Similarly, in the legislative history, Congress emphasized that

> "[i] vestors should be able to obtain the best, most economic and fair execution of their orders and be assured that, because of open competition among market makers, the total market for each security is as liquid and orderly as the characteristics of that security warrant."

Facilitating a national market system is among the most difficult and challenging of the many tasks that Congress has assigned to the Commission. The costs and consequences of change frequently seem so substantial—and, paradoxically, so difficult to quantify—that the Commission must weigh carefully, in each instance and in advance, the workability and feasibility of each proposed system change.

After the close of the period covered in this *Annual Report,* the Commission issued a comprehensive policy statement setting forth its views as to those initiatives necessary to facilitate the establishment of a national market system. The Commission believes that this blue-print provides the opportunity for the securities industry to move ahead. The thrust of the plan is to provide a framework within which the industry can marshall its own efforts, not to displace or replace industry initiative. The Commission is, however, prepared to act aggressively to fill any void.

Our capital markets are today the finest in the world. Nothing in the restructuring that those markets are currently undergoing is inconsistent with maintaining and enhancing that pre-eminence. Indeed, the development of the national market system is an integral part of assuring the continued strength of, and confidence in, our securities industry and the private enterprise system it supports. Our obligation—both the industry's and the Commission's—is to get on with the task of building a future for our securities markets which will ensure that their strength, liquidity, vitality, and fairness endure.

Corporate Accountability. A second important element contributing to confidence in our capital markets is public trust in the stewardship which is exercised over publicly-owned enterprises. On April 28, 1977, the Commission announced a broad re-examination of its rules relating to shareholder communications and to shareholder participation in the corporate electoral process and corporate governance generally. In that proceeding, the Commission is studying such issues as the role of disclosure in supporting a more effective accountability system, the extent to which the Commission's authority under the federal securities laws can be used to strengthen the corporate accountability process, and whether it would be appropriate for the Commission to recommend any additional legislation in this area.

In my view, the Commission's goal should be to foster an environment

in which corporate managers are subject to meaningful oversight, by an independent board of directors, of the manner in which they discharge their stewardship responsibilities. Our objective should be to stimulate that scrutiny, not to draw lines which confine or restrain it. The area does not readily lend itself to solution by prescription, and the Commission's chief aim will be to encourage the private sector to utilize the opportunities available to it to enhance and maintain public trust.

Accounting Matters. The independent accountant is the cornerstone of the financial reporting system and thus is a crucial element in investor protection and in fostering confidence in the fairness of the securities markets. Because of the role which accountants play under the federal securities laws, the Commission, in turn, has a special commitment to insuring that the Nation continues to be served by a strong and independent accounting profession.

The accounting profession is in the midst of fundamental and far-reaching changes. For example, accountants are engaged in creating a self-regulatory process designed to enhance public confidence in auditor independence, in the integrity of the audit process, and in the vehicles through which accounting and auditing standards are promulgated. There is no pre-existing model which the profession can emulate in working toward these goals. Thus, the development of a self-regulatory structure and process is, by its nature, experimental and will involve a certain amount of trial and error. In my view, the SEC Practice Section has the potential to meet the objectives Congress and the Commission share in this area. Whether or not that experiment ultimately succeeds is one of the central questions which must be answered during my term as Chairman.

Representatives of the private sector are working to address a broad spectrum of issues touching on the theoretical underpinnings of accounting and auditing. The Financial Accounting Standards Board's conceptual framework project is a central focus of that effort. One area which will prove to be especially important, and which has implications in the corporate accountability area, is the role of "soft information" in augmenting the traditional focus of financial statements. Accordingly, the Commission intends to work closely with the profession as it seeks to develop the conceptual framework for accounting.

Disclosure. In enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress adopted the philosophy of full disclosure as the lynch-pin of investor protection. The Commission has traditionally been sensitive to the need periodically to re-evaluate its rules, particularly in the dynamic and changing field of disclosure, in order to insure that its requirements harmonize with the changing realities of the market-place and impose no unnecessary burdens on the capital formation process. Most recently, during 1976, the Commission appointed an Advisory Committee on Corporate Disclosure to examine the disclosure system and, on November 3, 1977, that

committee concluded 21 months of intensive effort with the transmittal to the Commission of its final report. This report provides the Commission with valuable insights and, because of the significance of the Advisory Committee's work, the Commission will carefully consider, and act as rapidly as possible, on the committee's recommendations.

The Commission is also sensitive to the fact that its disclosure requirements can serve to influence corporate conduct. This power requires that the Commission be mindful of both the objectives which Congress sought to attain in the federal securities laws and of the public's expectations concerning corporate conduct. The Commission will act judiciously in this area.

Investment Company Deregulation. Another goal which I have set for the Commission to accomplish during my term as Chairman is to revise the investment company regulatory structure to place a fuller measure of responsibility on fund management while at the same time insuring that management will be held responsible for the consequences of its stewardship. With this objective in mind, the Commission, after the close of the fiscal year, announced its intention to undertake a systematic review of the Investment Company Act and the rules, regulations and interpretative positions which have developed under it over the years. The major objective of the study will be to develop a system of rules which are consistent, comprehensive, and designed to give reasonably clear guidance to prudent fiduciaries. The result should be a regulatory system which relies primarily on funds and their managers—rather than on the Commission—to discharge their duties properly but which preserves a strong oversight function for the Commission.

Options Trading. The burgeoning growth of trading in standardized options has strained the Commission's ability to keep abreast of developments in this new component of our securities markets. The area is an especially difficult one since, on the whole, potential trading strategies are more complex and investor sophistication less well developed than in the traditional equity markets. As a result of rapid developments in this field, during mid-1977 the Commission instituted a moratorium on the further expansion of options trading and initiated a comprehensive review extending to all aspects of the trading of standardized options and the regulation of that trading. The Commission's study includes an inquiry into the adequacy of existing Commission and self-regulatory rules to govern trading and selling practices and the surveillance capabilities to prevent and detect fraudulent and manipulative acts and practices in connection with options trading, and exploration of the relationship between the development of standardized options markets and the development of the national market system for securities.

The Commission has assembled a talented and diversified staff from its various Offices and Divisions to conduct this study, and I anticipate that their work will be concluded during fiscal 1979. The intellectual and regulatory complexities inherent in overseeing

large-scale options trading will, however, undoubtedly continue to demand considerable Commission resources in the coming years.

Enforcement. The Commission is committed to maintaining the vigor, effectiveness and credibility of its enforcement program. The enforcement tools which Congress has conferred upon the Commission are potent and can have profound effects both on those against whom action is taken and on those who look to those actions to provide an educative process concerning the Commission's conception of the standards of corporate conduct which the federal securities laws impose. Accordingly, while the Commission will continue aggressively to investigate and prosecute all categories of violations of the federal securities laws, we will also periodically channel a portion of our enforcement effort into specific problem areas. The Commission's experience has demonstrated that systematic enforcement attention in a given area encourages voluntary compliance with the federal securities laws and thus, in the long run, reduces the degree to which the Commission must rely on enforcement efforts to accomplish its investor protection goals.

My fellow Commissioners and I recognize that every authorization of enforcement proceedings demands a careful exercise of our judgment. We will continue to direct the development and implementation of an enforcement program which serves the ends embodied in the federal securities laws and which maintains a reasoned balance between enforcement remedies and regulatory devices as the means to those ends.

Resource Management. As this description of the Commission's priorities illustrates, there has probably never been a period in the Commission's history when its resources have been devoted to so many demanding projects with far-reaching consequences. In order to enhance the efficiency with which our resources are utilized, we have undertaken several important efforts to strengthen the Commission's internal management and data-handling capabilities.

For example, the Commission's personnel management program is receiving increased attention. One of our most fundamental goals in this area is to develop a comprehensive and meaningful performance evaluation system for the Commission's staff. We are seeking to develop objective criteria for evaluating the work of Commission personnel and for apprising them of their strengths and of the areas in which improvement is warranted. This is an especially challenging task since attorneys comprise the bulk of the Commission's professional staff, and there have been few attempts objectively to evaluate attorney performance on which we can build. A strengthened evaluation system should, however, pay significant dividends, both in terms of more effective management capability and reduced turnover.

In conjunction with the performance evaluation system, the Commission intends to develop an expanded training program in order to develop and foster the specific skills most closely related to the Commission's work. Training which emphasizes both skills and overall

management techniques can be of considerable benefit to our staff. An expanded training program will also aid us in our upward mobility program by which individuals in lower skill positions can become qualified for more sophisticated and higher paying positions. Further, a more coherent performance evaluation system will assist recruiting efforts by permitting the Commission to identify the abilities and attributes important in various phases of the Commission's work. This, in turn, will contribute to a more meaningful and effective affirmative action program.

Fundamentally, the Commission's stock-in-trade is information. Accordingly, we have begun implementing a long-range program to convert the existing and cumbersome paper record system to a micrographics file. Ultimately, the micrographics file will incorporate a computerized access and retrieval system and should yield significant savings in both manpower and time. The Commission is also significantly upgrading its computer facilities in order to keep pace with the development of advanced market surveillance techniques, work flow tracking systems, information retrieval, and other demands inherent in effective regulation of the securities markets.

* * *

While the foregoing touches briefly on the highest priority matters with which the Commission can anticipate dealing over the next few years, it is, of course, impossible to outline in a brief letter all of the important challenges facing the Commission or to predict the areas in which new market developments will demand Commission attention. I am, however, confident that the close and supportive relationship which the Commission has enjoyed in the past with those Congressional committees concerned with our work will continue. The Commission stands ready to provide additional information concerning its work to Congress whenever necessary to aid the legislative process.

Sincerely,

Harold M. Williams
Chairman

COMMISSIONERS AND PRINCIPAL STAFF OFFICERS

(As of April 1, 1978)

COMMISSIONERS	Term expires June 5
HAROLD M. WILLIAMS of Calif., Chairman	1982
PHILIP A. LOOMIS, JR., of Calif.	1979
JOHN R. EVANS of Utah	1978
IRVING M. POLLACK of New York	1980
ROBERTA S. KARMEL of New York	1981

Secretary: GEORGE A. FITZSIMMONS

Executive Assistant to the Chairman: RALPH C. FERRARA

PRINCIPAL STAFF OFFICERS

BENJAMIN MILK, Executive Director

RICHARD H. ROWE, Director, Division of Corporation Finance
  FRANCIS T. VINCENT, JR., Associate Director
  WILLIAM C. WOOD, Associate Director
  MARY E. T. BEACH, Associate Director

STANLEY SPORKIN, Director, Division of Enforcement
  WALLACE L. TIMMENY, Deputy Director
  IRWIN M. BOROWSKI, Associate Director
  THEODORE SONDE, Associate Director
  DAVID P. DOHERTY, Associate Director
  THEODORE A. LEVINE, Associate Director

ANDREW M. KLEIN, Director, Division of Market Regulation
  SHELDON RAPPAPORT, Deputy Director
  LLOYD H. FELLER, Associate Director
  KATHRYN B. MCGRATH, Associate Director

SYDNEY H. MENDELSOHN, Director, Division of Investment Management
  MARTIN C. LYBECKER, Associate Director
  LEE B. SPENCER, Associate Director

AARON LEVY, Director, Division of Corporate Regulation
  GRANT GUTHRIE, Associate Director

HARVEY PITT, General Counsel
  PAUL GONSON, Associate General Counsel

DAVID FERBER, Solicitor to the Commission

ANDREW L. ROTHMAN, Director, Office of Public Affairs
CHILES T. A. LARSON, Deputy Director
A. CLARENCE SAMPSON, Acting Chief Accountant
J. RICHARD ZECHER, Director of Economic and Policy Research
ROGER W. SPENCER, Deputy Director
(VACANT), Director, Office of Opinions and Review
WILLIAM S. STERN, Associate Director
HERBERT V. EFRON, Associate Director
WARREN E. BLAIR, Chief Administrative Law Judge
LAWRENCE H. HAYNES, Comptroller
RICHARD J. KANYAN, Service Officer
JAMES C. FOSTER, Director, Office of Personnel
(VACANT), Director, Office of Reports and Information Services
FRANKLIN E. STULTZ, Associate Director
JOHN D. ADKINS, Director, Office of Data Processing

REGIONAL AND BRANCH OFFICES

REGIONAL OFFICES AND ADMINISTRATORS

Region 1. New York, New Jersey.—William D. Moran, 26 Federal Plaza, New York, New York 10007.

Region 2. Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, Maine.—Michael J. Stewart, 150 Causeway St., Boston, Massachusetts 02114.

Region 3. Tennessee, Virgin Islands, Puerto Rico, North Carolina, South Carolina, Georgia, Alabama, Mississippi, Florida, part of Louisiana.—Jule B. Greene, Suite 788, 1375 Peachtree St., N.E., Atlanta, Georgia 30309.

Region 4. Illinois, Indiana, Iowa, Kansas City (Kansas), Kentucky, Michigan, Minnesota, Missouri, Ohio, Wisconsin.—William D. Goldsberry, Room 1204, Everett McKinley Dirksen Bldg., 219 S. Dearborn St., Chicago, Illinois 60604.

Region 5. Oklahoma, Arkansas, Texas, part of Louisiana, Kansas (except Kansas City).—Richard M. Hewitt, 503 U.S. Court House, 10th & Lamar Sts., Fort Worth, Texas 76102.

Region 6. North Dakota, South Dakota, Wyoming, Nebraska, Colorado, New Mexico, Utah.—Robert H. Davenport, Two Park Central, Room 640, 1515 Arapahoe Street, Denver, Colorado 80202.

Region 7. California, Nevada, Arizona, Hawaii, Guam.—Gerald E. Boltz, Suite 1710, 10960 Wilshire Boulevard, Los Angeles, California 90024.

Region 8. Washington, Oregon, Idaho, Montana, Alaska.—Jack H. Bookey, 3040 Federal Building, 915 Second Ave., Seattle, Washington 98174.

Region 9. Pennsylvania, Maryland, Virginia, West Virginia, Delaware, District of Columbia.—Paul F. Leonard, Room 300, Ballston Center Tower No. 3, 4015 Wilson Boulevard, Arlington, Virginia 22203.

BRANCH OFFICES

Cleveland, Ohio 44113.—1020 Standard Bldg., 1370 Ontario St.

Detroit, Michigan 48226.—1044 Federal Bldg.
Houston, Texas 77002.—Room 5615, Federal Office & Courts Bldg., 515 Rusk Ave.
Miami, Florida 33131.—Suite 1114 DuPont Plaza Center, 300 Biscayne Boulevard Way.
Philadelphia, Pennsylvania 19106.—Federal Bldg., Room 2204, 600 Arch St.
St. Louis, Missouri 63101.—Room 1452, 210 North Twelfth St.
Salt Lake City, Utah 84111.—3rd Floor, Federal Reserve Bank Bldg., 120 South State St.
San Francisco, California 94102.—450 Golden Gate Ave., Box 36042.

COMMISSIONERS

HAROLD M. WILLIAMS, *Chairman*

Chairman Williams was born on January 5, 1928, in Philadelphia, Pennsylvania. He received his B.A. from UCLA in 1946, graduating Phi Beta Kappa at the age of 18. Three years later he was awarded his J.D. degree from Harvard University Law School. He joined a Los Angeles law firm in 1949 where he specialized in tax and corporation law and remained until 1955 except for an interruption to serve as a U.S. Army legal officer during the Korean emergency. He joined Hunt Foods and Industries, Inc., in 1955 as Associate Tax Counsel. He subsequently became Tax Counsel, Vice President-Finance and Executive Vice President. In 1964, he became President of Hunt-Wesson Foods, Inc. In 1968, he was elected President of Hunt Foods and Industries, Inc., and with the formation of Norton Simon, Inc., later that year—resulting from consolidation of Canada Dry Corporation, Hunt Foods and Industries, Inc., and McCall Corporation—he was named Chairman of the new company's Finance Committee. In 1969, he assumed the additional post of Chairman of the Board of Norton Simon, Inc. In July of 1970, Mr. Williams became the Dean and Professor of Management of the UCLA Graduate School of Management. During his administration, the School achieved national ranking, including recognition as the leading graduate business school in a public university. During the 1973 energy crisis, Mr. Williams took leave to serve as full-time Energy Coordinator for the City of Los Angeles. While at UCLA, Mr. Williams also served as Director of Norton Simon, Inc., Phillips Petroleum Company, ARA Services, Inc., CNA Financial Corporation, Signal Companies, Inc., and Montgomery Street Income Securities, and as a Trustee of the Aerospace Corporation. In his service to the community, Mr. Williams acted as Co-Chairman for the Public Commission on Los Angeles County Government, a subcommittee chairman of the Mayor's *ad hoc* Committee on Los Angeles City Revenues, a member of the State of Cali-

fornia Commission for Economic Development and of the California Citizens Commission on Tort Reform, and a member of the SEC Advisory Committee on Corporate Disclosure.

PHILIP A. LOOMIS, JR.

Commissioner Lommis was born in Colorado Springs Colorado, on June 11, 1915. He received an A.B. degree, with highest honors, from Princeton University in 1938 and an LL.B. degree, cum laude, from Yale Law School in 1941, where he was a Law Journal editor. Prior to joining the staff of the Securities and Exchange Commission, Commissioner Loomis practiced law with the firm of O'Melveny and Myers in Los Angeles, California. Commissioner Loomis joined the Commission's staff as a consultant in 1954, and the following year he was appointed Associate Director and then Director of the Division of Trading and Exchanges. In 1963, Commissioner Loomis was appointed General Counsel to the Commission and served in that capacity until his appointment as a member of the Commission. Commissioner Loomis is a member of the American Bar Association and the American Law Institute. He received the Career Service Award of the National Civil Service League in 1964, the Securities and Exchange Commission Distinguished Service Award in 1966, and the Justice Tom C. Clark Award of the Federal Bar Association in 1971. He took office as a member of the Securities and Exchange Commission August 13, 1971, and is now serving for the term of office expiring June 5, 1979.

JOHN R. EVANS

Commissioner Evans was born in Bisbee, Arizona, on June 1, 1932. He received his B.S. degree in Economics in 1957, and his M.S. degree in Economics in 1959 from the University of Utah. He was a Research Assistant and later a Research Analyst at the Bureau of Economics and Business Research at the University of Utah, where he was also an instructor of Economics during 1962 and 1963. He came to Washington in February 1963, as Economics Assistant to Senator Wallace F. Bennett of Utah. From July 1964 through June 1971 Commissioner Evans was minority staff director of the U.S. Senate Committee on Banking, Housing and Urban Affairs and served as a member of the professional staff from June 1971 to March 1973. He took office as a member of the Securities and Exchange Commission on March 3, 1973, and is now serving for the term expiring June 5, 1978.

IRVING M. POLLACK

Commissioner Pollack was born in Brooklyn, New York, on April 8, 1918. He received a B.A. degree, cum laude, from Brooklyn College in 1938 and an LL.B. degree, magna cum laude, from Brooklyn Law School in 1942. Prior to joining the

Commission's staff he engaged in the practice of law in New York City after serving nearly four years in the United States Army, where he gained the rank of Captain. Mr. Pollack joined the staff of the Commission's General Counsel in October 1946. He was promoted from time to time to progressively more responsible positions in that office and in 1956 became an Assistant General Counsel. A career employee, Mr. Pollack became Director of the Division of Enforcement in August 1972 when the SEC's divisions were reorganized. He had been Director of the Division of Trading and Markets since August 1965; and previously served as Associate Director since October 1961. In 1967 Mr. Pollack was awarded the SEC Distinguished Service Award for Outstanding Career Service, and in 1968 he was a co-recipient of the Rockefeller Public Service Award in the field of law, legislation and regulation. Mr. Pollack took the oath of office on February 13, 1974 as a member of the Securities and Exchange Commission, and is now serving for the term expiring June 5, 1980.

ROBERTA S. KARMEL

Commissioner Karmel was born May 4, 1937, in Chicago, Illinois. She received a B.A. from Radcliffe College in 1959 and an LL.B. from New York University School of Law in 1962. From 1962 to 1969, Mrs. Karmel worked in the New York Regional Office of the Securities and Exchange Commission as an attorney, then attorney branch chief, then assistant regional administrator. From 1969 to 1972 she was an associate with Willkie, Farr & Gallagher in New York. Mrs. Karmel was a partner in Rogers & Wells from 1972 through September 1977, and an adjunct professor at Brooklyn Law School from 1973 through 1977. She has been a member of the American Bar Association Federal Regulation of Securities Committee since 1973. She has also served on the Association of the Bar of the City of New York Committee on Securities Regulation, Committee on Administrative Law, and Committee on Professional Responsibility. She is the author of numerous articles in legal journals. Mrs. Karmel took the oath of office as a member of the Securities and Exchange Commission on September 30, 1977, for a term expiring on June 5, 1981.

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Part 1
Important Developments

Part 1 Important Developments

MARKET REGULATION

During fiscal year 1977 and the Transition Quarter,[1] the Commission undertook several actions of far-reaching importance to the securities industry, the securities markets and the investing public. These Commission actions reflected primarily efforts to implement the Securities Acts Amendments of 1975 (1975 Amendments),[2] which significantly revised and expanded the Securities Exchange Act of 1934 (Exchange Act).

A major element of the 1975 Amendments was the Congressional direction to the Commission to facilitate the establishment of a national market system for securities. The creation of a national market system is a complex task which involves the efforts of the Commission, the self-regulatory organizations and the members of the securities industry. During the fiscal period, significant steps were taken in certain areas toward the implementation of a national market system. The Commission reviewed, and announced a proceeding to consider amending existing exchange rules which continue to limit or condition the ability of members to effect transactions in securities otherwise than on an exchange. The Commission also continued to consider proposals for implementation of certain contemplated components of the national market system in addition to the existing consolidated transaction reporting system, including a composite quotation system and limit order protection and market linkage systems.

Off-Board Trading Rules

Section 11A(c)(4) of the Exchange Act, as amended by the 1975 Amendments, directs the Commission to review rules (off-board trading rules) of all exchanges "which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges." That Section further directs the Commission to report the results of its review to the Congress and to commence a proceeding, pursuant to Section 19(c) of the Exchange Act, "to amend any such rule imposing a burden on competition which does not appear to the Commission to be necessary or appropriate in furtherance of the purposes of [the Exchange Act]." On September 2, 1975, the Commission reported the results of its initial review pursuant to Section 11A(c)(4) to the Congress.[3] In that report, the Commission stated that certain off-board trading rules impose burdens on competition which the Commission was not prepared to conclude were necessary or appropriate in furtherance of the purpose of the Ex-

change Act. Accordingly, the Commission simultaneously issued a release (September 1975 Release) instituting a proceeding, pursuant to Section 19 (c), to determine whether to modify or eliminate those off-board trading rules.[4]

The September 1975 Release proposed, and solicited comment on, three alternative forms of a Commission rule amending (to various degrees) exchange rules imposing off-board trading restrictions on members and announced that the proceeding would seek to determine: (a) the extent to which existing off-board trading rules engendered significant anti-competitive effects; (b) whether, if such rules were anti-competitive, there were countervailing considerations which outweighed the need to eliminate or revise such rules at that time; and (c) whether such rules could appropriately be modified so as to further the purposes of the Exchange Act.[5]

The Commission held eight days of public hearings concerning its proposals to amend off-board trading rules during October 1975 and received numerous written submissions concerning these proposals and related issues from representatives of the securities industry, government agencies and the public. On December 19, 1975, the Commission issued a release (December 1975 Release) announcing the adoption, effective March 31, 1976, of Exchange Act Rule 19c–1.[6] Rule 19c-1 reflected the Commission's determination that certain aspects of then existing off-board trading rules imposed burdens on competition which could not be justified in terms of the regulatory objectives of the Exchange Act.

Rule 19c–1 amended exchange off-board trading rules in order to eliminate prohibitions that prevented exchange members from effecting over-the-counter agency transactions in listed equity securities with third market makers and non-member block positioners.[7] The Commission determined that other off-board trading restrictions, which precluded members from executing over-the-counter transactions in listed securities as principal, or as agent, in "in-house" agency crosses or otherwise, had anti-competitive effects. Although the Commission believed those effects to be significant, particularly in the case of off-board principal restrictions, the Commission determined to allow exchange rules imposing those restrictions to remain in effect pending further review.[8] While the Commission found that off-board principal restrictions deprive the markets of the benefits which could be derived from improved market maker competition, the Commission concluded in the December 1975 Release that there was a need, before amending or abrogating those restrictions, for further study concerning the timing of the elimination of those restrictions and concerning the implementation of additional regulatory and technological changes to ensure that market maker competition would develop in a fair and orderly manner.[9] The Commission stated, however, that it would reconsider this decision in 1977 after it had had the benefit of the conclusions and advice of the National Market Advisory Board(NMAB) and had evaluated the progress by that date toward a national market system. The Commission further stated that if, at that time, it still appeared appropriate, the Commission would establish a firm date for removal of off-board trading restrictions.[10]

As to remaining off-board agency restrictions, the December 1975 Release recognized that it remained for

the Commission to determine whether those restrictions are anti-competitive in significant ways and what, if any, action should be taken with respect to them.[11] The Commission stated, however, that it would devote further study to the restrictions and solicited comment on them from the NMAB.

In September 1976, the NMAB supplied its views to the Commission with respect to remaining off-board agency restrictions applicable to "in-house" agency crosses.[12] A majority of the NMAB's members concluded that existing restrictions on such transactions either do not impose a significant burden on competition, or, to the extent that they do, that burden is outweighed by countervailing policy considerations.[13] Four members of the NMAB concluded that those restrictions are anti-competitive and that the alleged adverse consequences from their removal are speculative and have been exaggerated.[14]

In February 1977, the NMAB expressed its tentative conclusions with respect to off-board trading restrictions.[15] In its letter, the NMAB noted that the Commission had found that off-board trading restrictions are basically anti-competitive and concluded that the purposes of the Exchange Act do not justify the maintenance of such restrictions generally and indefinitely by the exchanges.[16] The NMAB also indicated that it favored removing such restrictions gradually and with caution.

In May 1977, the NMAB delivered to the Commission a full statement of its recommendations with respect to off-board trading restrictions, including an extensive discussion of various issues associated with their removal.[17] The NMAB affirmed its tentative conclusion that the purposes of the Exchange Act do not justify maintenance of off-board trading restrictions generally and indefinitely. The NMAB also expressed its belief, however, that removal of those restrictions might have a profound effect on the manner in which listed securities are traded and, therefore, that such restrictions should be removed only after certain additional facilities and rules are in place.[18] The NMAB noted that there were divergent views among the NMAB's members as to whether and when particular restrictions should be removed, and as to which facilities and rules must be in place before such removal.[19]

In particular, the NMAB identified the following as appropriate collateral steps in conjunction with the possible removal of off-board trading restrictions: (a) implementation of a composite quotation system; (b) consideration of the need to adopt rules and develop facilities to enhance limit order protection to the maximum practical extent; (c) examination of the need to adopt rules to protect retail customers in their transactions with dealers; (d) revision of Commission and self-regulatory rules to achieve "equal regulation" of exchange specialists and off-board market makers; (e) review of brokers' "best execution" responsibilities; and (f) reconsideration of the current practice of reporting last sale prices in the consolidated transaction reporting system without giving effect to commissions, comission equivalents or differentials.[20]

In June 1977, after considering the views of the NMAB and progress toward a national market system since adoption of Rule 19c–1, the Commission issued a release (June 1977 Release) announcing the commencement of a proceeding, pursuant to Section 19(c), to consider (1) rulemaking to amend existing exchange off-board trading rules and (2) in the

event off-board trading rules are amended, rulemaking to govern over-the-counter transactions in listed securities between dealers and certain categories of persons.[21] In the June 1977 Release, the Commission reaffirmed its belief that exchange off-board trading restrictions impose burdens on competition and requested persons believing that such restrictions should be retained to present views, data and arguments for the Commission's consideration.

In the June 1977 Release, the Commission published for comment proposed amendments to Exchange Act Rule 19c–1 and proposed Rule 19c–2. The proposed amendments to Rule 19c–1 would revise the existing rule to permit an exchange member to effect over-the-counter agency transactions in listed equity securities with any other person not also represented as agent by that member (*i.e.*, precluding only "in-house" agency cross transactions). Proposed Rule 19c–2 would, after December 31, 1977, permit an exchange member to effect over-the-counter principal and "in-house" agency cross transactions in listed equity securities reported in the consolidated transaction reporting system ("reported securities").

To govern over-the-counter transactions in reported securities between dealers and certain categories of persons in the event existing off-board trading rules are amended, the Commission proposed alternative Exchange Act Rules 15c5–1[A], [B], [C] and [D]. These rules are designed to prevent exchange members from dealing unfairly with customers with respect to reported securities after the removal of off-board principal restrictions.

(a) Rule 15c5–1[A] would preclude any dealer from effecting over-the-counter transactions in reported securities as principal with any person other than a broker, dealer, or financial institution.

(b) Rule 15c5–1[B] would permit any dealer effecting over-the-counter transactions in reported securities with any person other than a broker, dealer, or financial institution to do so only at a price at least as favorable to such person as the highest bid (in event the dealer is buying) or lowest offer (in the event the dealer is selling), in a size equal to or greater than the transaction size reflected in a display of quotation information disseminated pursuant to proposed Exchange Act Rule 11Ac1–1.

(c) Rule 15c5–1[C] would require confirmation disclosure of the highest bid and lowest offer made available to quotation vendors in accordance with proposed Rule 11Ac1–1 and displayed on a terminal or other display device at the time of any over-the-counter principal transaction in a reported security with any person other than a broker, dealer, or financial institution.

(d) Rule 15c5–1[D] would require dealers effecting over-the-counter transactions in reported securities with any person other than a broker, dealer, or financial institution to do so at prices no less favorable to such persons than they know (or reasonably should believe), under all the relevant circumstances, could be obtained for such persons if they were to act for them in an agency capacity.

The Commission held nine days of public hearings in August 1977 (August 1977 Hearings) on its proposed rulemaking and received numerous written submissions concerning these proposals and related issues from representatives of the securities industry, government agencies, members of the Congress and the public. Persons appearing at the August 1977 Hearings, and other commentators on

the June 1977 Release, strongly urged the Commission to take a more affirmative role in facilitating establishment of a national market system. Many commentators also expressed concern over removal of off-board trading rules prior to implementation of appropriate market linkage facilities. At the end of the fiscal period, the Commission was engaged in studying the issues related to off-board trading rules and market linkage facilities and in evaluating the responses to the rule proposals announced in the June 1977 Release.

Composite Quotation System

In both its 1972 *Future Structure Statement*[22] and 1973 *Policy Statement*,[23] the Commission indicated its support for a composite quotation system (CQS) which would make quotations from all market makers universally available and its belief that a CQS would facilitate the development of a national market system. The Commission initiated the development of a CQS by proposing in 1972,[24] and reproposing in 1974,[25] Exchange Act Rule 17a–14. As reproposed, that rule would have required that quotations be "reported" by self-regulatory organizations (and certain broker-dealers) pursuant to a plan (similar to that required by Exchange Act Rule 17a–15 for the consolidated transaction reporting system), that would be filed with and declared effective by the Commission and would provide for the availability of such quotations to vendors of market information on a real-time, current and continuing basis.

Following reconsideration of proposed Rule 17a–14, the Commission determined to adopt a different approach to enhancing the availability of quotation information and announced that it had requested that all exchanges eliminate by May 11, 1975, any of their rules or practices which restricted access to or use of quotation information disseminated to quotation vendors.[26] In announcing that all exchanges had complied with its request, the Commission stated that such compliance would facilitate the development of a national market system.[27]

During 1976, however, it became increasingly apparent that the lack of reliable quotation information from the various markets was impeding private and self-regulatory organization efforts to establish a CQS, the absence of which, in turn, was perceived as impeding the development of a national market system. On July 29, 1976, the Commission proposed for comment Rule 11Ac1–1 under the Exchange Act (July 1976 Proposal), which would have required exchanges to collect from their specialists, and the National Association of Securities Dealers, Inc. (NASD) to collect from third market makers, quotations (with size if indicated) to be disseminated by those self-regulatory organizations to quotation vendors.[28] Although the proposed rule neither specified the manner in which, nor the frequency with which, the quotations were to be collected, processed, and made available, it would have required specialists and third market makers to communicate their quotations promptly in accordance with procedures established by the particular exchange or the NASD for timely dissemination to quotation vendors.

The proposed rule would have required, subject to certain exceptions, that covered quotations be "firm." In particular, any specialist or third market maker who was presented with an order for the purchase or sale of any eligible security (other than an odd-lot order) would have been required to stand ready to execute a transaction in that security in any amount

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up to his published quotation size (or, in the event no quotation size was disseminated, a normal unit of trading) at a price at least as favorable to the buyer or seller as his most recently published bid or offer. That requirement would not have applied if, after dissemination of his published quotation but before the specialist or third market maker received an order, (1) a transaction in that security was effected either on the floor of the particular exchange or by the third market maker, or was reported in the consolidated transaction reporting system, or (2) the specialist or third market maker had communicated a superseding quotation. If, however, the specialist or third market maker had not communicated his superseding quotation within three minutes after a transaction or a report of a transaction, he would have been obligated to buy or sell that security in accordance with the general rule as to firmness.

On June 14, 1977, the Commission issued a release publishing a revised version of proposed Rule 11Ac1-1.[29] Under the revised proposal, the basic regulatory approach of the July 1976 Proposal would be retained. As reproposed, Rule 11Ac1-1 would require that the exchanges and the NASD establish and maintain procedures for collecting, processing and making available to quotation vendors quotation information relating to reported securities. Similarly, the proposed rule would continue to require that brokers and dealers subject to its provisions supply quotations to their exchanges or the NASD for dissemination to quotation vendors (although dissemination of size greater than a normal unit of trading would continue to be optional). Finally, the proposed rule would retain the requirement that quotations made available to and displayed by quotation vendors be firm up to the size displayed, subject to the same exceptions contained in the July 1976 Proposal (*i.e.*, for revised quotations, intervening transactions and trade reports) and a new exception intended to accommodate unusual market conditions.

The principal change in reproposed Rule 11Ac1-1 from the July 1976 Proposal relates to the manner of collecting quotation information from exchanges. Under the revised proposal, an exchange would be responsible for making available a single quotation for each reported security (with size if indicated) reflecting the highest bid and lowest offer communicated at the location (or locations) designated for trading of that security on the exchange floor. That quotation would not necessarily be the quotation of a specialist, but would reflect the buying and selling interest of all brokers and dealers (responsible brokers and dealers) expressing their interest as bids or offers. If, for example, the single quotation made available by an exchange reflected the bid of a specialist acting as agent for an order on his book and the offer of a broker in the crowd, the responsibility for that quotation (in terms of the firmness requirements of the Rule) would be shared — the specialist would be responsible for execution of orders to sell at his bid and the broker in the crowd would be responsible for orders to purchase at his offer. The revised rule would not make any significant change in the requirements for collection of quotations of third market makers, who would be deemed to be "responsible brokers or dealers" with respect to their bids or offers for reported securities. Third market makers would be responsible for their quotations in a manner similar to responsible brokers or dealers who were exchange members.

At the end of the fiscal period, the

Commission was analyzing comments received regarding the revised proposal, as well as examining the national market system issues associated with the development of a CQS.

Composite Limit Order Book

In the December 1975 Release announcing the adoption of Rule 19c–1, governing off-board trading by exchange members, the Commission indicated that it was considering steps to provide comprehensive limit order protection consistent with the public interest. The Commission expressed its belief that public limit orders and the methods by which they are kept play an important role in the securities markets. The Commission found, however, that existing exchange mechanisms for the storage of limited price orders are intrinsically unable to provide full protection for those orders and that regulatory devices employed to ensure execution of limit orders create certain adverse effects which outweigh their laudable objectives. The Commission indicated that the solution to these problems appeared to lie in the utilization of existing advanced technology to construct a computerized central limit order repository (composite book) designed to provide comprehensive limit order protection to investors.

In March 1976, the Commission and the NMAB jointly solicited public comment on these issues, including the policy and technical questions associated with certain specified characteristics of any composite book, and on possible alternative facilities to a composite book.[30] Extensive written comments were received from numerous individuals, firms and self-regulatory organizations. In addition, the NMAB, following extensive deliberations on issues associated with the development of (and alternatives to) a composite book, provided comprehensive written comments on these issues to the Commission in January 1977.[31]

At the time of its initial proposal, a composite book was perceived primarily as a means of protecting public limit orders in a market environment characterized by off-board trading by exchange members. Since that time, however, the composite book has come to be viewed as capable of performing a comprehensive order integration function, thereby addressing certain market fragmentation concerns associated with removing the remaining off-board trading rules.[32] Such a market linkage facility also would, in the view of some commentators, enhance market making competition. Other commentators believed that a composite book with certain characteristics would lead to the eventual demise of exchanges, thereby eliminating rather than enhancing competition among exchanges and between exchanges and markets other than exchanges. As the fiscal period ended, the Commission was actively considering the issues associated with implementation of a composite book, particularly in the context of its consideration of the removal of off-board trading rules.

Consolidated Transaction Reporting System

The Commission assisted in the implementation of the consolidated transaction reporting system (consolidated system), which became fully operational in 1976. As previously reported,[33] the consolidated system developed as a result of the Commission's adoption in 1972 of Exchange Act Rule 17a–15. The consolidated system disseminates, over its Network A, last sale reports of transactions executed in all reporting markets for securities listed on the New York Stock Exchange (NYSE) and, over its Network B, reports or trans-

actions in all reporting markets for securities listed on the American Stock Exchange (Amex) and selected regional listings. Last sale reports in both Network A and Network B securities are disseminated by means of a high speed data transmission line which enables investors and market professionals to have such information available on a real-time basis regardless of any delays in the low speed ticker network during periods of heavy trading. During the fiscal period, the consolidated system operated smoothly, substantially free of reporting disruption due to system failure.

During the period since the enactment of the 1975 Amendments, the Commission staff has met frequently with securities information processors who disseminate consolidated last sale information and with the Consolidated Tape Association (CTA), an association of self-regulatory organizations which oversees the operation of the consolidated system and is registered under Section 11A(b) of the Exchange Act as a securities information processor. Other developments include:

(a) The Commission's granting of conditional exemptions to certain foreign securities information processors from the display requirements of Rule 17a–15.[34]

(b) The Commission staff's continuing study of whether the existing prohibition on retransmission by securities information processors of consolidated last sale information on a continuous basis should be modified or eliminated in light of the standards now contained in Section 11A of the Exchange Act.

(c) The Commission staff's consideration of the related issues of whether market identifiers should be displayed on the low speed ticker network and whether vendors should be required to display consolidated last sale information, rather than last sale information from any single market center, on interrogation devices by means of the easiest access routine.

(d) The Commission staff's consideration of the continued appropriateness of exemptions from the general reporting requirements applicable to transactions in eligible securities.

(e) The CTA's study of the occasional problem of late reporting on the low speed ticker network during periods of unusually active trading.

(f) The CTA's study of new procedures to govern reporting by the consolidated system during regulatory trading halts in certain market centers.

Market Linkage Systems

During the August 1977 Hearings, various commentators urged that off-board trading rules not be removed without the establishment of an appropriate electronic linkage among existing market centers. In addition to evaluating the need for development of a composite book,[35] certain commentators suggested that the Commission carefully consider existing industry proposals to develop an intermarket execution system (IME) or an automated regional market system (RMS). During the fiscal period, the Commission also received a request from the Midwest Stock Exchange (MSE) for access to the Common Message Switch (CMS), which forms part of a communications system linking the Amex and the NYSE to their member firms.[36] In addition, the Commission has monitored the expansion of exchange automated order routing and formula pricing services.

The IME proposal, first announced by the National Market Association and subsequently endorsed by the NYSE,[37] involves a communications linkage which would permit orders to be sent from one market center to

another. A broker in one market center seeing a favorable quotation displayed in the CQS would be able to use the IME to send an order to the market center displaying the favorable quotation. Each market center would process orders received through the IME in the same manner as other orders originating outside of the market center. The IME would also accommodate the exchange of information among market centers before the opening. At the August 1977 Hearings, the NYSE and Pacific Stock Exchange (PSE) announced an agreement in principle to develop an IME, participation in which would be open to all market centers.

In addition to the IME proposal, certain regional exchanges advised the Commission during the August 1977 Hearings of their informal agreement to develop the RMS, which would use, with certain modifications, the WHAM automated trading system operating on the Cincinnati Stock Exchange.[38] The RMS would permit, but not require, limit orders for selected securities to be entered into the system from any participating exchange and would permit automatic execution of such limit orders through the system. At the close of the fiscal period, the pilot phase of RMS operation was commencing.

In March 1977, as more fully discussed below,[39] the MSE applied to the Commission under Section 11A(b)(5) of the Exchange Act for review of an alleged denial of access to the CMS by Securities Information Automation Corporation (SIAC), which operates the CMS for the Amex and the NYSE.[40] The CMS is a computer facility which provides an interface between the order routing systems of various brokerage firms and the trading and data processing facilities of the Amex and the NYSE. In May 1977, the Commission's staff by letter requested that the NMAB comment on the CMS access request by the MSE.[41] On October 4, 1977, the Commission by letter requested that the MSE, the Amex, the NYSE and SIAC respond to specified policy and jurisdictional issues posed by the MSE application.[42]

National Market Advisory Board

The 1975 Amendments directed the Commission to establish the NMAB, to be comprised of fifteen members, a majority of whom must be associated with brokers and dealers. The initial membership of the NMAB was announced by the Commission in August 1975, and the NMAB has conducted monthly public meetings since September 1975. The initial terms of the NMAB members would have expired on September 30, 1977, but the Commission extended those terms until December 31, 1977.

The 1975 Amendments directed the NMAB to furnish to the Commission its views on significant regulatory proposals made by the Commission or any self-regulatory organization concerning the establishment, operation and regulation of the securities markets. The NMAB was also directed to recommend to the Commission the steps it finds appropriate to facilitate the establishment of a national market system and to study the possible need for modifying the Exchange Act's scheme of self-regulation so as to adapt it to a national market system, including the possible need to establish a new self-regulatory organization to administer the national market system. The NMAB was directed to report, and did report, the results of its study on self-regulation to the Congress by December 31, 1976.[43]

In December 1975, in adopting Rule 19c–1 governing off-board trading by members of national securities exchanges, the Commission requested

the NMAB to study three specific problems: (1) in-house agency cross transactions, (2) off-board principal trading restrictions, and (3) the development of a composite book. The NMAB furnished its views to the Commission on in-house agency crosses in September 1976, on the development of a composite book in January 1977, and on off-board trading restrictions in February and May 1977.[44] At the end of the fiscal period, the NMAB was engaged in developing final views on various issues related to the development of a national market system.

Short Sale Regulation

On December 21, 1976, the Commission announced that it had ordered a public investigatory and rulemaking proceeding to determine whether regulation of short sales of the type currently provided by the Commission's primary short sale rule, Exchange Act Rule 10a–1, was needed in the current regulatory environment.[45] In connection with that proceeding, the Commission published for comment three versions of proposed temporary Exchange Act Rule 10a–3(T) and proposed Exchange Act Rule 10b–11. The alternative versions of proposed Rule 10a–3(T) would partially suspend, in varying degrees, the operation of the "tick" test provisions of Rule 10a–1, while proposed Rule 10b–11 would establish explicit borrowing requirements in connection with short sales. The Commission at the same time published for comment a revised version of proposed Exchange Act Rule 10b–21 (together with amendments to Rule 17a–3),[46] restricting short sales of securities before and during underwritten public offerings of securities for cash and establishing certain additional recordkeeping requirements with respect to short sales. Proposed Rule 10b–21 is designed to prevent manipulative short selling practices in connection with underwritten public offerings of securities of the same class as outstanding securities. The Commission was at the close of the fiscal period, reviewing comments on its various short sale proposals and considering whether any alteration of the present regulatory scheme is appropriate.

Regulation of the Options Markets

At the beginning of fiscal year 1977, four national securities exchanges listed standardized call options for trading under pilot programs approved by the Commission in prior years.[47] The Chicago Board Options Exchange, (CBOE), had initiated the listing of standardized options for trading in April 1973; the Amex and the Philadelphia Stock Exchange (Phlx), began listing options in January and June 1975, respectively; and the PSE began such listing in March 1976. During the fiscal year, all four exchanges expanded their options programs to accommodate an enlarged trading volume indicative of increasing public interest in this investment vehicle. In addition, the MSE began listing options in December 1976, and the Commission received formal rule change proposals from the NASD and the NYSE to initiate pilot programs for the trading of standardized options through their facilities by their members.[48]

In 1977, the Commission for the first time allowed each of the five national securities exchanges which list standardized call options under pilot programs (the Options Exchanges) to initiate carefully controlled and strictly limited pilot programs for the listing of standardized put options[49] on those exchanges.[50] The put option proposals provided that put options would be traded in the same manner, and subjected to the same types of regulation and exchange surveillance, as call options. To permit careful monitoring of the pilot

programs, however, put option trading on each exchange was limited to five option classes.[51] Although each of the Options Exchanges listed the maximum number of five put option classes, no exchange listed any put option classes on underlying securities whose options were already listed on another exchange.

At the close of the fiscal year, the CBOE had 1,309 members trading listed options on 95 underlying securities. Its average daily trading volume reached 92,305 contracts (compared to 89,000 in the previous fiscal year).[52] On the Amex, 512 members had options trading privileges and listed options on 64 underlying stocks, with average daily trading volume increasing to 39,332 contracts from approximately 35,000 contracts in fiscal year 1976.[53] The Phlx had 231 members authorized to trade in options on 37 underlying securities. Its average daily trading volume was 7,977 contracts (compared to 2,600 in the preceding fiscal year).[54] In its first year of operation, the PSE had 460 members qualified for options trading and its average daily trading volume was 5,685 contracts on 33 underlying securities.

On December 8, 1976, the Commission approved a proposal by the MSE to implement a pilot program for the listing and trading of standardized option contracts.[55] Trading on the MSE options floor commenced on December 10, 1976, and, through the end of fiscal year 1977, 304 members traded an average daily volume of 1,850 contracts on 17 underlying securities.

During the fiscal year, the Commission approved proposals by the Options Exchanges to revise the minimum qualification standards relating to the underlying securities for listed options in light of experience with the listed options markets. The listing standards contained in the MSE proposal to trade options[56] were substantively identical to the revised standards proposed by the other Options Exchanges.[57] These standards, which establish minimum requirements for the initial and continued qualification of a stock as an underlying security for listed options, include requirements relating to the issuer of the underlying security (regarding issuer deficits, net income, defaults on certain payments, and meeting of reporting requirements under the Federal securities laws) and to the quality of the market for the underlying security (regarding volume of trading, market price per share, number of publicly held shares and number of public shareholders).

The MSE's option contracts, like those of other Options Exchanges, are made fungible through standardization of such contract variables as the expiration date and striking price. The MSE and other Options Exchanges are participants in The Options Clearing Corporation, which issues, guarantees and files a registration statement (in compliance with the Securities Act of 1933) for all exchange-traded options, and which clears and settles all transactions in such options. The MSE reports transactions occurring on its options floor to the consolidated system for reporting last sale information on all listed options administered by the Options Price Reporting Authority. In an attempt to limit the number of transactions which do not result in completed contracts between the parties to a trade because of disagreement as to the terms of the execution, the MSE, like the PSE and the Phlx, has instituted procedures permitting direct floor comparison of order tickets by the buyer and seller for each option trade before the trade is given to the MSE for clearance and settlement.

Option trading on the MSE is conducted in a manner similar to trading on the CBOE and the PSE. Thus, on

the MSE the agent (broker) and principal (dealer) functions of the traditional unitary specialist are divided between two categories of individuals: (1) employees of the MSE called Order Book Officials (agents), corresponding to the CBOE's "Board Brokers," and (2) competing market makers (dealers).[58]

During the fiscal year, there was a significant increase in the number of call option classes listed and traded on more than one Options Exchange. (dually listed options).[59] Currently, a dually listed option class must have the same expiration dates and exercise prices on every exchange on which it is listed.[60] Because of the other features of standardization, this permits trading of such options on any exchange on which they are listed, and provides brokers with the opportunity to "shop markets" to obtain the best available price.

The dual listing of option classes has produced competition between the Options Exchanges for public order flow, and that competition may have resulted in greater liquidity and narrower market quotations in those classes. At the same time, however, dual listing of options has given rise to inappropriate trading behavior including trading activity by exchange members which is apparently designed solely to inflate artificially the volume of trading in a dually listed class.[61] Such trading was designed to attract to the exchange the order flow of brokers whose selection between competing options markets on behalf of their public customers is based largely (if not solely) on the relative aggregate options trading volume of each market. The Commission warned that such trading by exchange members may violate Sections 9 and 10 of the Exchange Act, and cautioned brokers against relying solely on aggregate volume in making selections among competing market centers.[62] The Commission also expressed its expectation that affected Options Exchanges would take appropriate steps to discipline members responsible for such trading and would institute improved surveillance procedures to prevent its recurrence.[63] In addition, the Commission inspected the Options Exchanges' surveillance programs[64] to determine their adequacy to monitor questionable trading practices, and held three conferences with surveillance personnel from the Options Exchanges to discuss surveillance related matters.[65]

The Options Moratorium

At the end of the fiscal year, there were pending before the Commission several proposed rule changes by the Options Exchanges, the NASD and the NYSE designed either to expand existing programs for the trading of options or initiate new programs (the Expansion Proposals). For example, each Options Exchange requested the Commission's authorization both to expand the maximum number of securities on which it could list call options[66] and to include on its list of eligible underlying securities those which are listed solely in the over-the-counter market.[67] In addition, the NASD and the NYSE formally proposed rule changes to initiate pilot programs for the trading of standardized options.

While the Commission had approved several previous proposals that expanded the trading of standardized options, circumstances indicating the occurrence of abusive practices in the trading of standardized options, and the apparent inability of the existing self-regulatory programs to address the incidence of such abuses, caused the Commission to become increasingly concerned that existing self-regulatory programs might be strained unacceptably if the Commission approved the

Expansion Proposals.[68] Accordingly, on July 18, 1977, the Commission requested that the Options Exchanges refrain from expanding their options programs through the addition of new classes of options not already listed for trading, and announced that it had determined to initiate an overall review of standardized trading since the commencement of the first pilot program for such trading in 1973 on the CBOE.[69] The Commission also stated that it did not expect to approve any of the Expansion Proposals until it had completed the review.

In announcing its review, the Commission set forth several areas that it would consider, including: (1) the implications and effects of option trading, (2) whether self-regulatory and Commission oversight programs with respect to those matters have kept pace adequately with the dramatic expansion of standardized options trading, and (3) whether those programs are adequate for the prevention of fraudulent and manipulative acts and practices, for the maintenance of fair and orderly markets and for the protection of investors.[70]

After a brief and preliminary review of problems in the options markets, the Commission reaffirmed its decision to conduct a review of options trading by announcing the commencement of its investigation and study of the adequacy of options regulation.[71] The Commission also proposed Exchange Act Rule 9b-1(T), which would defer the expansion of existing options trading programs and the initiation of new programs until the study is completed.[72] At the same time, the Commission announced the commencement of consolidated disapproval proceedings with respect to the Expansion Proposals.[73] Although the Commission had not completed its investigation and study at the end of the fiscal period, it announced its intention to do so as expeditiously as possible, and stated that it expected to require, and would anticipate receiving, the cooperation of the affected self-regulatory organizations in achieving that goal.[74]

Unlisted Trading in OTC Securities

The 1975 Amendments added Section 12(f)(1)(C) to the Exchange Act, which permits exchanges, based upon standards set forth in new Section 12 (f)(2) of the Act to obtain unlisted trading privileges in securities traded solely over-the-counter (OTC). On March 25, 1977, the PSE submitted an application for unlisted trading privileges in the common stock of Pacific Resources, Inc. (PRI),[75] the first such application to be considered by the Commission pursuant to Section 12(f)(1)(C). On June 22, 1977, the Commission ordered a hearing by written submission on the PSE application.[76] Submissions were received from the PSE, PRI and the NASD.

The PSE argued in its submission that there had not been any problems arising from the dual market in PRI stock. It provided evidence that a grant of unlisted trading privileges to the PSE, which would allow a continuation of the then current environment, would not have any adverse effect on the existing market for PRI stock.[77] The PSE suggested a denial of the application could impair the marketability of PRI stock by eliminating competition between markets. Since it would allow a continuation of mixed exchange and OTC trading in PRI stock, the PSE further contended, a grant of unlisted trading privileges would be a step toward the development of a national market system. The PSE also asserted that, if the application were to be approved, transactions in PRI stock should not be exempted from the requirements of

Exchange Act Rule 17a–15 and the Consolidated Tape Plan with respect to last sale reporting.

The NASD and PRI contended, on the other hand, that the PSE had failed to meet the requirements of Section 12(f)(1)(C) of the Act or to demonstrate that substantial progress has been made toward a national market system. They also asserted that the PSE's denial of direct access to the PSE floor to non-member dealers constitutes an unjustified barrier to competition since it prevents a non-member dealer from obtaining best execution when an opportunity for such execution existed on the PSE. The lack of a composite quotation system, they further argued, is a further reason for the Commission to disapprove the application. The NASD argued that if the application were granted, the last sale reporting requirements should not apply to OTC transactions in PRI stock, because of (1) the burden such requirements would impose upon OTC dealers; (2) the differences in pricing policies between the exchange and OTC markets; and (3) the impact such requirements would have on market-making interest and the attendant depth and liquidity of the market in PRI stock.

At the end of fiscal year 1977, the PSE application and the submissions received during the hearing were under consideration by the Commission, while trading in PRI stock continued both over-the-counter and on the PSE.

Trading by Exchange Members

Section 11(a)(1) of the Exchange Act prohibits, with certain specified exceptions (such as market-making activities), any member of a national securities exchange from effecting any transaction on that exchange for its own account, the account of an associated person, or an account with respect to which it or any of its associated persons exercises investment discretion. Under Section 11(a), the Commission has broad authority, in keeping with the overall Congressional proposes, to fashion either more flexible or more restrictive standards in light of changing conditions. Section 11(a)(3) provides that the prohibitions in Section 11(a)(1) do not apply before May 1, 1978, to transactions effected on an exchange by those who were members of that exchange on May 1, 1975.

As the Commission reported in its last annual report,[78] the Commission published a release in January 1976 adopting a temporary rule to implement the statutory exemption for certain proprietary transactions by members (Exchange Act Rule 11a1–1(T), proposing a rule exempting certain transactions for members' associated persons (proposed Exchange Act Rule 11a1–2), and raising several broad policy questions.[79] On March 18, 1977, the Commission published a second release on Section 11(a)[80] which (1) discussed the background concerning institutional membership and the development of Section 11(a), (2) proposed three new rules under Section 11(a) and other provisions of the Exchange Act, and (3) summarized the comments received in response to its 1976 rule proposals and request for comments.

The rule proposals announced in March 1977 would affect a significant amount of trading currently effected on the exchanges. Proposed Exchange Act Rule 11a2–1 would prohibit all proprietary trading by exchange members (other than odd-lot dealers' transactions) unless, among other things, such transactions yielded priority on the basis of time of entry to non-members' orders. Proposed Exchange Act Rule 11a1–3 would, in effect, exempt agency transactions by

an exchange member for a managed institutional account if the member did not charge that account any separate fee based on transactions. The last proposal set forth in that release, Exchange Act Rule 11a2–2, would permit any member to effect transactions for an account that is subject to the general prohibition under Section 11(a)(1) so long as an unaffiliated member executed the transaction on the exchange floor and neither the member initiating the transaction nor any of its associated persons participated in the execution of the transaction after the order had been transmitted to the exchange floor. Each of the proposed rules published in March would have required that, before any transaction could be effected on an exchange under the terms of the rule proposals, that exchange would have to have filed and secured Commission approval of a plan for access to the exchange. Such a plan would address the availability of membership and access to member and exchange services as well as the scope of regulation over members' associated persons. At the end of the fiscal period, the Commission was analyzing the comments received in response to the March release and formulating a final determination on the rule proposals pending under that provision, as well as any legislative recommendations that might be appropriate.[81]

Enforcement Obligations of National Securities Exchanges and Associations

Section 19(g) of the Exchange Act requires each self-regulatory organization to comply with the Act, the rules and regulations thereunder and its own rules, and, absent reasonable justification or excuse, to enforce compliance therewith by its members and persons associated with its members. Section 19(g)(2) authorizes the Commission to adopt rules relieving any self-regulatory organization of its enforcement obligations with respect to specified provisions of the Exchange Act or the rules and regulations thereunder. Following the guidance provided by the Congress in the legislative history of the 1975 Amendments, the Commission published for comment on May 26, 1976,[82] proposed Exchange Act Rule 19g2–1. That rule set forth proposed standards for relieving national securities exchanges and associations[83] of certain enforcement responsibilities, primarily with respect to persons associated with members who are neither controlled by those members nor engaged in securities transactions subject to the self-regulatory organization's direct surveillance.

On November 18, 1976, the Commission adopted Rule 19g2–1.[84] As adopted, it establishes three classes of persons "associated with" a member and, depending upon the classification, relieves exchanges and associations from the obligation of taking specified kinds of enforcement action against them. For the most part, the rule does not relieve exchanges and associations of their enforcement obligations with regard to members and "securities persons," which are generally defined as general partners, officers (or persons occupying a similar status or performing similar functions) or employees of a member, or a registered broker-dealer which is associated with a member, if such persons effect transactions in securities through the member by use of facilities supervised or maintained by the exchange or association. Moreover, persons who control a member are similarly left within the scope of exchange or association enforcement obligations.[85]

Rule 19g2–1 does relieve exchanges

and associations of any enforcement obligations under Sections 12 (other than Sections 12(j) and 12(k)),13, 14 (other than Sections 14(b)), 15(d) and 16 of the Exchange Act and the rules thereunder, except for actions normally taken with respect to any person who is not a member or associated with a member. Similarly, under the rule, exchanges and associations are relieved of qualification, examination, report filing, and routine inspection and examination requirements with respect to all associated persons except securities persons whose functions are not solely clerical or ministerial.

Allocation of Regulatory Responsibilities Among Self-Regulatory Organizations

Section 17(d)(1) of the Exchange Act authorizes the Commission to allocate the regulatory responsibilities of self-regulatory organizations with respect to members or participants of more than one self-regulatory organization (dual members). Allocation of regulatory responsibilities is intended to promote cooperation and coordination among self-regulatory organizations and to remove impediments to and foster the development of a national market system and a national system for the clearance and settlement of securities transactions.

On October 28, 1976, the Commission adopted Exchange Act Rule 17d–2,[86] which establishes a procedure to promote an allocation of regulatory responsibilities based upon an assessment by self-regulatory organizations of their own capabilities. The rule permits any two or more self-regulatory organizations to propose jointly to the Commission a plan for allocating specific duties for dual members. Plans declared effective by the Commission would relieve self-regulatory organizations of specific responsibilities designated to another party under the terms of the plan. If the proposed plans filed with the Commission do not establish a comprehensive program of regulation, the Commission, on its own motion after due consideration of the statutory criteria, may designate a self-regulatory organization to bear specific responsibilities with respect to dual members.

As of the close of the fiscal year, the self-regulatory organizations had filed 21 plans with the Commission pursuant to Rule 17d–2. Of the plans received by the Commission, 15 embody agreements between two exchanges with respect to dual members. In general, these plans expand the responsibilities currently assigned to the exchange which is the designated examining authority (DEA) under Rule 17d–1 and Section 9(c) of the Securities Investor Protection Act of 1970.[87] Under the plans the DEA generally would review financial reports, inquiries, complaints, and public communications and would conduct specified examinations, investigations and disciplinary actions with respect to dual members, except for those related to transactions in listed options and transactions on the floor of the exchange.

In addition, the Commission received proposed agreements executed by the NASD with four national securities exchanges—the BSE, the CSE, the MSE and the PSE. These plans would effect a transfer of regulatory responsibility, other than the regulation of floor and options activities, from the regional exchanges to the NASD. Further, the NASD's agreements with the PSE and the MSE would assign to the NASD the responsibility to enforce compliance with rules related to options transactions.

The five Options Exchanges have filed a single plan which would establish a mechanism for allocating the

enforcement responsibility relating to options transactions. Any exchange member qualified to conduct a non-member business on more than one Options Exchange would be assigned a "primary regulator." Where an Options Exchange has been designed as the DEA, that exchange would be the primary regulator; where an Options Exchange has not been designated as the DEA, the responsibilities of primary regulator would be assigned to Options Exchanges on an annual basis.

Under the plan, customer inquiries and complaints relating to more than one marketplace would be reviewed by the exchange initially receiving the complaint. Investigations, including those for terminations of registered personnel for cause, concerning more than one marketplace, would be conducted by the primary regulator unless that responsibility were assigned to another Options Exchange. The primary regulator also would conduct, at a minimum, an annual sales practice examination of each broker or dealer for which it was responsible.

At the close of the fiscal period, the Commission had not approved any of the proposals for allocation but was analyzing the provisions of the plans, considering recommendations for their amendment, reviewing comments received, and evaluating the manner in which the plans might be integrated into a comprehensive and effective program of regulation.

Regulation of Securities Information Processors,Access to Order-Routing Systems

In fiscal year 1976, the Commission commenced its regulatory program pursuant to Section 11A(b) of the Exchange Act with respect to the operations of exclusive securities information processors.[88] During fiscal year 1977, the Commission granted the registration of one additional exclusive securities information processor and exempted another such processor from registration. The additional registration was granted to NASDAQ, Inc. (which temporarily had been exempted from registration).[89] The additional exemption from registration was granted to Bradford National Clearing Corporation (Bradford).[90] Bradford had entered into a facilities management agreement with P.C. Service Corporation (PCSC), a wholly-owned subsidiary of the PSE, pursuant to which Bradford undertook to perform, among other functions, the securities information processing services then performed by PCSC on an exclusive basis for the PSE.[91]

As discussed above, in fiscal year 1977, the Commission received its first request under Section 11A(b)(5), which was added to the Exchange Act by the 1975 Amendments, to review a limitation of access to the services of a registered securities information processor.[92] In that request, the MSE applied to the Commission for review of an asserted denial of access by SIAC, a registered securities information processor jointly owned by the NYSE and the Amex, to the Common Message Switch (CMS).

The CMS is an automated data processing device which receives orders from NYSE and Amex members' offices, "translates" these orders into language acceptable to terminals on the floor of either exchange, routes the orders directly to specialists' post on the NYSE or Amex, and, finally, transmits execution reports back to originating brokers. In its request to SIAC, the MSE sought to link to the CMS to enable brokerage firm subscribers to designate orders for delivery to the MSE floor, as an alternative to sending their orders either to the NYSE or Amex floor.[93] In denying the MSE's request, SIAC stated that in its operation of the

CMS it was not acting as a "securities information processor" within the meaning of Section 11A(b)(5) of the Exchange Act and, in any event, lacked contractual and proprietary authority to provide the requested access to a system owned by the NYSE and the Amex.

In May 1977, the Commission's staff, by letter, requested that the NMAB comment on the CMS access request by the MSE.[94] In view of a number of threshold jurisdictional questions raised by the MSE application for Commission review, the Commission, on October 4, 1977, requested the MSE, SIAC, the NYSE and the Amex to submit their views on such questions. At the same time, the Commission noted that, under Section 11A(c)(1)(E) of the Exchange Act, it has plenary rulemaking authority to ensure that "exchange members, brokers and dealers direct orders ...in a manner consistent with the establishment and operation of" a national market system. Accordingly, the Commission also requested the parties to address certain questions to assist the Commission in ascertaining whether the linking of the MSE and other market centers to the CMS would help perfect the mechanism of a national market system. The Commission intends to complete its review of the issues associated with the alleged denial of access during the early part of fiscal year 1978.

Notices by Self-Regulatory Organizations of Disciplinary Sanctions and Other Actions

Before adoption of the 1975 Amendments, the Commission's authority under the Exchange Act regarding disciplinary sanctions imposed by a self-regulatory organization upon its members was limited to review by the Commission of disciplinary and certain other adjudicatory actions taken by a registered securities association, *i.e.*, the NASD. The Commission lacked comparable authority to review disciplinary actions taken by national securities exchanges. Nor did the Commission have authority, except as to the NASD, to review other penalties imposed by a self-regulatory organization, including summary suspensions or limitations of membership, participation or association with a member, denials of membership or of association with a member, or prohibitions or limitations of access to services.

The 1975 Amendments expanded the Commission's jurisdiction to review disciplinary sanctions and denials of membership, participation, or association imposed by a self-regulatory organization (including clearing agencies for which the Commission is the appropriate regulatory agency). Section 19(d) of the Exchange Act requires a self-regulatory organization taking any such action to file a notice with the Commission in such form as the Commission, by rule, may prescribe. Any action requiring the filing of notice may be reviewed either on the motion of the appropriate regulatory agency (the Commission, except with respect to bank participants in bank clearing agencies) or on the application of any person aggrieved by such action. On the other hand, appeals taken to the Commission do not automatically stay an action, as previously was the case in appeals to the Commission from an NASD action, although the Commission may grant stays where appropriate.

Finally, under the 1975 Amendments, persons subject to a "statutory disqualification" may be barred from membership or participation in a self-regulatory organization. While a statutory disqualification does not necessarily bar a person from membership or

participation in a self-regulatory organization, it permits the self-regulatory organization to deny or condition such a person's membership or participation or association with a member and the Exchange Act requires the self-regulatory organization to take such action if the Commission so orders. A self-regulatory organization proposing to admit to membership, participation, or association a person subject to a statutory disqualification must give notice to the Commission 30 days before admission.

On July 8, 1977, the Commission adopted several rules setting forth notice and application requirements for self-regulatory organizations imposing disciplinary sanctions.[95] Exchange Act Rule 19d–1 prescribes the form and content of notices that those self-regulatory organizations for which the Commission is the appropriate regulatory agency must file with the Commission in connection with certain actions ordered by the self-regulatory organization including all final disciplinary actions, all denials of membership, participation or association with a member, all prohibitions or limitations of access to services, and all summary suspensions or limitations of membership, participation, or association. Exchange Act Rule 19d–2 prescribes the form and content of applications to the Commission for stays of final disciplinary sanctions and summary actions of self-regulatory organizations. Exchange Act Rule 19d–3 prescribes the form and content of applications to the Commission for review of final disciplinary sanctions, denials of membership, participation or association with a member, and prohibitions or limitations of access to services imposed by self-regulatory organizations. Finally, Exchange Act Rule 19h–1 prescribes the form and content of notices by self-regulatory organizations of proposed admissions to or continuances in membership, participation or association of any person subject to a statutory disqualification and applications to the Commission for relief from a statutory disqualification.

Registration and Regulation of Clearing Agencies

Section 17A(b) of the Exchange Act, which became effective on December 1, 1975, requires a clearing agency[96] to register with the Commission if it perfórms any clearing agency functions for any security other than an exempted security. The Commission must publish notice of the filing of an application for registration so that interested persons may comment on it and, within specified periods, must either grant registration by order or institute proceedings to determine whether registration should be denied.

By December 1, 1975, 13 clearing agencies had applied for registration. The registrations were declared effective as of that date for a period of 18 months, after the Commission determined that the operations and rules of those clearing agencies provided adequate safeguards for funds and securities in their custody or control.[97] The approach to registration incorporated in Rule 17Ab2–1 was intended to permit clearing agencies in operation before December 1, 1975, to be registered on an interim basis upon a finding that their operations were safe. At the same time, that approach was designed to afford the Commission sufficient time to consider fully the issues involved, particulary those pertinent to the establishment of a national clearance and settlement system, before making all the determinations called for by subparagraphs (A) through (I) of Section 17A(b)(3).

On September 1, 1976, the Commission instituted proceedings to de-

termine whether to make permanent the interim registrations previously granted to the 13 clearing agencies.[98] On June 1, 1977, the Commission proposed for public comment standards for making the determinations required by the Exchange Act in connection with the registration of clearing agencies.[99] In general, the proposed standards pertain to: participation requirements; fair representation; capacity to enforce rules; disciplinary actions and fair procedures; safeguarding of securities and funds; obligations to participants; participant charges; equitable allocation of reasonable dues, fees and other charges; and competitive consideration. These standards are intended to facilitate the establishment of a national clearance and settlement system by ensuring that all clearing agencies registered under the Exchange Act have the capacity, organization and rules necessary to participate in, and to advance the objectives of, that system. In response to its request for public comments, the Commission received letters commenting upon the proposed standards for permanent registration and was reviewing those standards at the end of the fiscal period.

Since December 1, 1975, four additional entities have applied to the Commission for registration.[100] One of these is the New England Securities Depository Trust Company (NESDTC). On September 24, 1976, the Commission granted the application of NESDTC for registration as a clearing agency on the same basis as it granted registration to the 13 clearing agencies registered with the Commission on December 1, 1975.[101]

Another entity which filed an application for registration as a clearing agency was the National Securities Clearing Corporation (NSCC), an entity formed to combine the clearing operations conducted by three registered clearing agencies in New York: the Stock Clearing Corporation, the American Stock Exchange Clearing Corporation and the National Clearing Corporation. In order to determine whether to grant or deny NSCC's application, the Commission, during fiscal year 1976, sought and received comments on many of the issues basic to the establishment of a national clearing system and the role of NSCC in that system.

On June 16-18, 1976, the Commission held public hearings at which representatives of the NASD, stock exchanges, brokerage firms, clearing agencies and other interested persons presented their views and responded to questions of the Commision and its staff. In addition, numerous letters of comment and other materials were received in connection with the hearings.[102]

In November 1976, after reviewing comment letters and the transcripts of public hearings, the Commission announced that it was considering approving, subject to four proposed conditions, the application of NSCC for registration as a clearing agency and requested public comment on the proposed conditions.[103] On January 13, 1977, the Commission granted NSCC's registration subject to certain conditions.[104]

Bradford National Clearing Corporation and Bradford Securities Processing Services, Inc., have appealed to the United States Court of Appeals for the District of Columbia Circuit to reverse the order granting registration to NSCC. Those entities, the Commission and certain other parties have filed briefs in the case, which was pending before the Court at the end of the fiscal year.[105]

Fourteen applications for exemption from registration as a clearing agency

were pending at the end of the fiscal period.[106] Since these applications are the first under the new clearing agency regulatory program, they present novel policy questions which will be resolved after the completion of the clearing agency permanent registration proceedings.

Transfer Agent Rules

Section 17A(c) of the Exchange Act, adopted as part of the 1975 Amendments, requires a transfer agent to register with its appropriate regulatory agency if it acts as a transfer agent for any security registered under Section 12 of that Act or for any security which would be registered but for the exemptions from registration for securities of registered investment companies (Section 12(g) (2) (B)) and for securities issued by insurance companies (Section 12(g) (2) (G)).

At the beginning of the fiscal year, the Commission's staff was evaluating the comments received on a series of transfer agent rules that had been proposed for comment pursuant to Section 17A(c).[107] On the basis of the review, the Commission published revised rules for public comment on February 24, 1977.[108] After evaluating the comments received, Exchange Act Rules 17Ad–1 through –7 were adopted on June 16, 1977.[109]

These rules, the first substantive rules in the transfer agent regulatory program, provide a comprehensive structure for the transfer of securities from one record owner to another. Rule 17Ad–2 treats most requests for the transfer of securities as routine items and requires registered transfer agents to cancel 90 percent of the old certificates presented and to issue new certificates within three business days. The remaining ten percent must be transferred promptly thereafter. Certain requests for transfer cannot be treated as routine, however, since they require special review, additional documentation from the person making the request, or an opinion of counsel before the securities can be transferred. Since the time required to accomplish most of these special steps is beyond the transfer agent's control, the rule does not set specific time limits for completing these requests but requires transfer agents to give them diligent and continuous attention and to complete the transfer as soon as possible.

Rules 17Ad–6 and –7 prescribe various recordkeeping and record retention requirements which are necessary to enable registered transfer agents to monitor their own activities, construct their records, if necessary, and to permit regulatory authorities to determine compliance with the adopted rules.

The Commission has continued to coordinate its plans for a transfer agent regulatory program with those of the three Federal bank regulatory agencies.[110] The Commission has also adopted, for transfer agents registered with the Commission, a rule and related form to be used for the withdrawal of registration.[111]

Rule 17Ad–3 provides that a registered transfer agent which repeatedly falls below the minimum performance level may not acquire new accounts or expand its transfer agent activities until it has demonstrated the ability to handle its current transfer agent workload in a timely fashion. Furthermore, a registered transfer agent may be required to provide notice of its performance failures to its appropriate Federal regulatory agency and to the issuers of securities for which it acts.

Rule17Ad–5 sets time periods within which registered transfer agents must respond to inquiries from investors. broker-dealers, or other persons con-

cerning the status of items presented for transfer and the status of shareholders accounts. This rule is designed to fulfill more completely the needs of investors who deal with transfer agents, to promote prompt identification of lost securities and to assist broker-dealers undergoing examination or seeking to comply with requirements relating to control of customer securities and net capital.

Single Denomination Stock Certificates

On October 7, 1976, the Commission approved a rule proposal of the NYSE to permit its listed companies to use, along with or in place of existing stock certificates, a new single denomination stock certificate (SDSC).[112] The three traditional forms of stock certificates include in the upper left and right hand corners an engraving that limits the share denomination represented by the certificate. An odd-lot certificate is designated "less than 100 shares," a single round-lot certificate is designated "100 shares" and the third type of certificate is designated "more than 100 shares."

The NYSE proposal permits companies to add a new SDSC that contains no corner denomination limitations. Instead, the SDSC must either have an engraved punch-out panel, with the share denomination indicated by punching out numbers in the panel, or must indicate the share denomination (1) in numbers in the share counter (the small box area currently used), (2) in numbers in a five-position matrix in the "open throat" area,[113] and (3) in words in the open throat area. All such share information must be printed with penetrating ink on top of fine-line intaglio engraving.

Proponents of the SDSC believe it permits new certificates to be issued more efficiently and inexpensively. Issuers using the SDSC need not maintain inventories of three different stock certificates and pay the cost of three engraving plates; similarly, a transfer agent using the SDSC does not have to handle three different types of certificates to issue new certificates of varying amounts. Moreover, because the SDSC can be fed through a computer-controlled high-speed printer, the proper number of shares and other information for each new certificate can be imprinted rapidly, and certificates of varying denominations can be printed without interruption.

Form TA–1

On March 21, 1977, the United States Court of Appeals for the Second Circuit upheld in *Continental Stock Transfer and Trust Company v. SEC*[114] the decision of the Commission to deny confidential treatment to the information supplied on Schedule B of Form TA–1 by a transfer agent when applying for registration. The issue presented was whether the exclusion from disclosure under the Freedom of Information Act[115] of trade secrets, commercial or financial information and privileged or confidential information, covers the issuer lists contained on Schedule B. The Court agreed with the Commission that, although the list of issues for which an applicant performs transfer agent functions is commercial information within the meaning of the statute, such lists already are available to the public and hence are not confidential. The Court held that neither the Commission's demand for the information nor the disclosure thereof constituted an abuse of discretion.

Street Name Study

The 1975 Amendments required the Commission to examine the practice of recording the ownership of securities

in other than the name of the beneficial owner (commonly referred to as "street" and "nominee" name registration) in order to determine whether the practice is consistent with the purposes of the Exchange Act and whether issuer-shareholder communications could be improved while retaining the benefits of the practice. A Preliminary Report was filed with Congress in December 1975, and a Final Report in December 1976.[116]

In the Final Report, the Commission examined the benefits of the practice and concluded that the use of street and nominee name registration is essential to the establishment of a national system for the clearance and settlement of securities transactions and the facilitation of securities processing generally. At the same time, the Final Report, while recognizing that the practice makes issuer-shareholder communications somewhat circuitous, concluded that the existing system for transmitting communications from issuers to beneficial shareowners is, on the whole, effective. The Final Report, however, recommended several steps to improve the performance of the system, including (1) requiring issuers to make more timely inquiries concerning the number of beneficial owners broker-dealers represent, (2) requiring broker-dealers to respond promptly to those inquiries, (3) requiring issuers to supply requested proxy materials and annual reports in a timely manner and, (4) requiring broker-dealers to forward those materials to their customers promptly. The Commission recently adopted Exchange Act Rule 14b–1 and amendments to Exchange Act Rule 14a–3(d) to implement those recommendations.[117]

The Final Report also examined the effects of the practice on the disclosure and dissemination of information regarding beneficial owners of securities. It concluded that current approaches to disclosure may not satisfy fully the objective of making publicly available information identifying shareowners who potentially may influence corporate management or affect the market in an issuer's securities. In this regard, the Final Report recommended implementation of a more comprehensive system for gathering and disseminating this information and legislation which would require those owners of more than five percent of an issuer's securities who are not covered currently by the ownership reporting requirements of the Exchange Act to file with the Commission a short statement providing certain ownership information.

In March 1977, Senate Bill 305 (S.305) was amended to effect the recommendations of the Final Report. Under S.305, disclosure would be required of, among other things, the person's identity, the number of shares, the nature of the interest and the time and manner of acquisition. Another section of that bill would require the Commission, within 30 months of enactment, to report to Congress on the effectiveness of the ownership reporting requirements and on the desirability and feasibility of reducing or otherwise modifying the current reporting thresholds. S.305 was signed by the President on December 20, 1977.[118]

Finally, the Report examined the effect of the practice on jurisdictional provisions of the Exchange Act which are based, in part, on shareholder-of-record standards. It concluded that the increased use of nominee and street name registration has not had the effect of excluding or removing issuers from the jurisdiction of the Exchange Act. The Final Report recognized, however, that the anticipated

increased registration of securities in the name of nominees of securities depositories might affect those jurisdictional standards in the future. To prevent this possibility, the Final Report recommended that the Commission use its authority under Section 12(g)(5) of the Exchange Act to propose a rule defining the term "held of record" to mean, for the purposes of the jurisdictional standards of subsection 12(g), that securities held by a depository or its nominees be considered to be held of record by the depositor of the securities. The Final Report also recommended that Section 15(d) of the Exchange Act be amended to clarify the Commission's authority to define "held of record" for purposes of that section. The recommended amendment to Section 15(d) was enacted into law as part of S.305.

Proposed Legislation to Amend the Securities Investor Protection Act

In July 1977, a bill to amend the Securities Investor Protection Act of 1970 (the SIPC Act) — H.R.8331, 95th Cong., 1st Sess. — was introduced and referred to the House Committee on Interstate and Foreign Commerce. Originally based on a 1974 Special Task Force Report to the Board of Directors of the Securities Investor Protection Corporation (SIPC),[119] the legislation was developed and refined over several years[120] and would effect important improvements in the SIPC Act. H.R.8331 is designed principally to afford public investors greater protection against the financial failure of stock brokers and to provide SIPC and the Federal courts with speedier and more flexible procedures to deal with difficulties created thereby.

In addition to raising the dollar limits of protection afforded under the SIPC Act, the bill would require that customer claims for securities be satisfied, to the maximum extent practicable, with securities rather than cash payments. To that end, a trustee would be permitted to purchase securities, as well as to reclaim securities pledged by the broker-dealer. In appropriate cases, the trustee could transfer all or part of the customer accounts to other SIPC members. To expedite the liquidation process, the bill would authorize SIPC to designate itself or one of its employees as trustee in particular cases. In certain small cases, SIPC would be permitted to avoid the necessity of court-supervised proceedings and to make payments directly to customers.

The Commission re-emphasized its support for the legislation and offered comments at hearings held by the House Subcommittee on Consumer Protection and Finance. By the end of the fiscal period, H.R.8331 was reported out by the Committee on Interstate and Foreign Commerce and, on November 1, 1977, it was passed by the House of Representatives.

NASD Underwriting Recapture Rules

On June 24, 1976, Judge Frankel of the Southern District of New York, in *Papilsky v. Berndt*,[121] held that underwriting recapture, a term which refers to arrangements through which the dealer distributing a new issue of securities arranges to return part of the underwriting "spread" to the purchaser, is available and legal, absent a ruling from the NASD or the Commission to the contrary. Although the court reached that conclusion after consideration of Article III, Section 24 (Section 24), of the NASD's Rules of Fair Practice,[122] the NASD, in response to requests from several broker-dealers, issued several opinions to the effect that Section 24 does prohibit underwriting recapture.

On February 17, 1977, the Commis-

sion requested that the NASD submit its interpretation of Section 24 to the Commission as a "proposed rule change." The NASD responded on April 1, 1977, by requesting that the Commission reconsider its position and by stating that its interpretation of Section 24 was merely an expression of the section as written. The NASD also requested an opportunity to address the Commission regarding its interpretation of Section 24, and a meeting with the Commission was held on May 26, 1977. In its statement before the Commission at that meeting, the NASD reasserted its prior position and further urged the Commission not to call into question Section 24 in order to avoid creating confusion and uncertainty with respect to the distribution of new issues of securities.

In a subsequent letter to the Commission dated June 13, 1977, the NASD announced that, through an *ad hoc* committee on Section 24, it was charting a program for the consideration of various aspects of the underwriting and distribution process. The NASD also stated at that time that the committee's conclusions would be expressed in the form of proposed rule changes, new rules, or interpretations. On September 23, 1977, the NASD circulated among its membership proposed rule changes and interpretations concerning securities distribution practices. These proposals generally reflect the determination by the NASD that underwriting recapture should be prohibited. The NASD projected that proposed rule changes would be submitted to the Commission during fiscal year 1978.

Independent Audit Committees

On March 9, 1977, the Commission, pursuant to Section 19(b) of the Exchange Act and Rule 19b–4 thereunder, approved an NYSE rule proposal that would require each domestic company with common stock listed on the NYSE, as a condition of initial and continued listing on that exchange, to establish not later than June 30, 1978, and maintain thereafter, an independent audit committee.[123] The audit committee is required to be comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member. Any domestic company not currently listed would be required to comply with the independent audit committee requirement upon listing.

The NYSE, the accounting profession, major corporations and others, including the Commission, have for many years recognized the advantages of corporate audit committees.[124] Stronger support for audit committees independent of management developed in the wake of recent revelations of questionable and illegal corporate payments.[125] In particular, the Commission has urged strengthening of independence and vitality of corporate boards of directors and has suggested that, at least initially, those principles could be implemented by amending the listing requirements of the NYSE and other self-regulatory organizations, rather than by direct Commission action.[126] Following preliminary study by the NYSE staff, a proposal was submitted to the NYSE Board of Directors in November 1976. The NYSE Board approved the proposal in principle and circulated it for comment by senior executives of listed companies and other interested parties. After revising the proposal in response to the comments received, the NYSE filed its rule as a proposed rule change under Section 19(b)(1). In approving that proposed rule change, the Commission requested the other national

securities exchanges and the NASD to consider adopting a similar rule for issuers whose securities are traded through the facilities maintained by the other exchanges and the NASD.

Confirmations

On September 16, 1976, the Commission announced a proposal to adopt Exchange Act Rule 10b–10 to establish revised delivery and disclosure requirements for confirmation slips sent to customers by brokers and dealers following the execution of a customer's order to buy or sell a security.[127]

The announcement of proposed Rule 10b–10 represented the beginning of an effort by the Commission to review confirmation requirements which, in large measure, had remained unchanged since the 1930's when the Commission adopted Exchange Act Rule 15c1–4. In proposing Rule 10b–10, the Commission pointed out that since the costs of regulation designed to promote investor protection are in the final analysis paid for, in large part, by the investor, it was seeking to adjust regulatory requirements for which compliance costs appear to be disproportionate to the practical benefits of investor protection thereby obtained. The Commission observed that its review would focus not only on the impact of new regulations on traditional business practices but also on the impact on emerging business practices of regulations drawn for an earlier era.

Proposed Rule 10b–10 reflected a number of changes, including (1) uniform application of the confirmation requirements to all brokers and dealers regardless of the marketplace where transactions are effected, (2) an adjustment of confirmation delivery requirements so that brokers and dealers could, under certain circumstances, deliver monthly or quarterly statements in lieu of confirmations sent immediately following the execution of an order, (3) the application of new disclosure requirements to dealers who trade as principals with their customers and (4) the modification of disclosure requirements applicable to brokers who act as agents for their customers.

After considering the views of numerous commentators, the Commission, on May 5, 1977, announced, effective January 1, 1978, the adoption of Rule 10b–10.[128] At the same time, the Commission announced that it would publish for comment shortly thereafter, as proposed amendments to Rule 10b–10, additional changes in confirmation requirements.

In adopting Rule 10b–10, the Commission provided that (1) the rule would not apply to transactions in municipal securities pending further consideration by the Municipal Securities Rulemaking Board of possible amendments of the Board's confirmation rule and (2) brokers could send quarterly statements in lieu of immediate confirmation in connection with transactions effected pursuant to certain periodic stock purchase plans. The Commission also adopted various revised disclosure requirements applicable to brokers who act as agents for customers.

Subsequently, the Commission published for comment several new or revised amendments to Rule 10b–10.[129] Those proposed amendments included (1) disclosure requirements, applicable to all brokers and dealers, relating to odd-lot differentials and the best bid and offer entered in the NASDAQ quotation system at the time of the transaction, (2) revised disclosure requirements applicable only to dealers trading for their own account with customers, and (3) a procedure for the use of quarterly statements in lieu of immediate confirmations in connection

with certain transactions in securities issued by investment companies. The comment period for the proposed amendments expired on September 9, 1977, and the Commission is considering the comments received.

Lost and Stolen Securities

Section 17(f)(1) of the Exchange Act, added by the 1975 Amendments, directs the Commission to formulate a program for the reporting of missing, lost, counterfeit and stolen securities, and to establish rules for making inquiry with respect to securities coming into the possession or control of certain financial institutions, in order to determine whether such securities have been reported as missing, lost, counterfeit, or stolen.[130] On December 6, 1976, the Commission adopted Exchange Act Rule 17f–1, establishing reporting and inquiry requirements under that section.[131] Following the adoption of certain technical amendments,[132] and the proposal of further amendments to the section regarding the role of transfer agents in the Lost and Stolen Securities Program,[133] a final, amended version of the rule was published on August 4, 1977.[134]

Section 17(f)(A) of the Exchange Act requires that reports and inquiries regarding missing, lost, counterfeit, or stolen securities be made to the Commission or a "person designated by the Commission." In order to implement the reporting and inquiry requirements of Rule 17f–1 in an efficient manner, the Commission instituted a pilot program, ending December 31, 1978, in which a private entity would be designated to perform several functions under the Commission's direction. The Commission published "Criteria for a Lost and Stolen Securities Reporting and Inquiry System" and solicited submissions of proposed systems from entities interested in serving as the Commission's designee during the pilot program.[135] After analysis of the submissions, the Commission designated the Securities Information Center,Inc. (SIC), a subsidiary of ITEL AutEx, Inc.,[136] to receive reports and respond to inquiries on behalf of the Commission regarding all securities other than United States Government or Agency securities.[137] At the conclusion of the pilot program, the Commission will evaluate the effectiveness of Rule 17f–1 and the SIC reporting and inquiry system.

The reporting and recordkeeping provisions of Rule 17f–1(b) became effective on October 3, 1977. That paragraph sets forth specific time periods within which reports of thefts, losses, suspected counterfeiting, or recoveries of securities must be made. Reports must be made to a registered transfer agent for the issuer as well as to SIC and, in cases where criminal misconduct is suspected, additional reports must be made to the appropriate law enforcement agency. All reports must be made on Form X–17F–1A, "Missing, Lost, Stolen, Counterfeit Securities Report,"[138] although preliminary reports may be made by telephone or telex.

The inquiry and other provisions, set forth in Rule 17f–1, will become effective on January 2, 1978. The rule requires various financial institutions to determine whether securities coming into their possession or being held by them under certain circumstances have been reported as missing, lost, counterfeit, or stolen. Exceptions to the general inquiry requirements are intended to make inquiry unnecessary in most instances. In order to avoid undue disruption of the normal course of commercial transactions, inquiry is required only in those circumstances most likely to involve missing, lost, counterfeit, or stolen securities. Cer-

tain additional exemptions are applicable during the pilot program. Inquiries that are not required may nevertheless be made at any time.

When an inquiry reveals that securities have been reported as missing, lost, counterfeit, or stolen, the Exchange Act and rules thereunder require only that the inquiring institution be provided with the name of the institution reporting the loss. The inquiring institution is expected to follow current business practices in dealing further with securities known to be lost or stolen.[139]

Fingerprinting of Securities Professionals

In March 1976, the Commission adopted Exchange Act Rule 17f–2[140] to implement the Congressional intention that persons be fingerprinted if they are engaged in the sale of securities, having access to securities, monies, or original books and records relating thereto, or supervising persons engaged in such activities, and that persons not so engaged be exempt.[141]

The rule became effective on July 1, 1976, for persons entering the securities industry after that date. Persons already employed by or associated with entities subject to the rule on that date originally were exempted until January 1, 1977, although the Commission later extended that deadline until January 1, 1978, upon the condition that 25 percent of those persons required to be fingerprinted under the Rule were in fact fingerprinted during each calendar quarter of 1977.[142]

The Rule requires a reporting organization to file a statement describing those classes of persons meeting the conditions for exemption and setting forth the security measures which the organization employs to ensure that only fingerprinted persons handle or process securities, monies, or original books and records relating thereto. In addition, fingerprint record retention requirements have been incorporated in Rule 17f–2(d), as well as in companion amendments to Exchange Act Rules 17a–3 and 17a–4, the Commission's recordkeeping and preservation requirements.

In order to avoid unnecessary regulatory duplication, Rule 17f–2(b) provides that persons whose fingerprints are submitted to the Attorney General for identification and appropriate processing pursuant to any other Federal, state or agency law, rule, or regulation may satisfy the fingerprinting requirements by compliance with those other requirements.

To facilitate the transmittal of fingerprint records, the Rule provides an exemption for persons whose fingerprints are submitted to the Attorney General through a self-regulatory organization pursuant to a plan filed by the self-regulatory organization and approved by the Commission. During the last fiscal year, the Commission approved fingerprinting processing plans submitted by six national securities exchanges—the Amex, BSE, MSE, NYSE, PSE, and Phlx—and the NASD. The Amex, BSE, and NYSE plans also provide for processing of fingerprint cards of transfer agents of exchange-listed issues. The NASD plan provides for transmittal of fingerprint records for transfer agents of securities traded over-the-counter and for members of the CBOE.

Commission Rates

Section 23(b)(4)(H) of the 1975 Amendments requires the Commission to include in its annual report to the Congress for each fiscal year beginning in 1975 and ending in 1980, a description of the effect of the absence of any schedule or fixed rates of commissions, allowances, discounts, or

other fees to be charged by members for effecting transactions on a national securities exchange on the maintenance of fair and orderly markets, and on the development of a national market system for securities. Five reports covering the first 20 months of commission price competition through December 31, 1976, were separately forwarded to Congress pursuant to Section 6(e)(3) of the Amendments, the last report on May 26, 1977.

Analysis of commission rates if now integrated into the Commission's ongoing monitoring of the financial condition of the industry. For the industry as a whole, securities commissions represented 45.8 percent of total revenue in 1976 and 42.9 percent during the first three quarters of 1977

From May 1, 1975, the beginning of negotiated commissions, to the end of September 1977, individual investors' commission rates have declined 12.3 percent. Institutional customers, reflecting their larger average order size and greater bargaining power, have negotiated discounts averaging 47.7 percent. Individuals paid an average of 26.3 cents per share on their September 1977 orders, which averaged 340 shares in size. Institutional orders averaged 1,575 shares in size and commissions averaged 13.6 cents per share for these customers.

Broker-dealers were affected by the elimination of fixed minimum commission rates more or less to the extent they serve institutional investors. Some firms which did a large portion of their total business with institutions have merged with more diversified firms. Several new discount broker-dealers have entered the industry to offer investors a reduced level of services at reduced commission rates. Those adjustments are continuing.

The elimination of fixed rates has not seriously affected the financial results of regional and over-the-counter firms. Market liquidity and the volatility of securities prices also do not appear to have been affected by the switch to competitively determined commissions.

Proposed Minimum Qualifications Rule

Section 15(b)(7) of the Exchange Act, as amended by the 1975 Amendments, provides that every registered broker and dealer and every person associated with them must meet minimum standards of training,experience and competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. Previously, only SECO broker-dealers[143] were subject to such minimum standards set by the Commission.

On June 27, 1977, the Commission published for comment proposed Exchange Act Rule 15b7-1, which would establish minimum qualification requirements for all registered brokers, dealers and associated persons.[144] The proposed rule would revise the presently applicable qualification standards by establishing various categories of principal and representative and by providing qualification standards for each category. Subject to certain conditions, however, an exemption from the proposed rule would be available for any broker-dealer complying with a comparable approved qualification rule of the NASD or a national securities exchange.

Section 31(b) Review

Section 31(b) of the 1975 Amendments permits the Commission, at any time within one year of the effective date of any amendment made by the 1975 Amendments to the Exchange Act, to notify any national securities exchange or national securities association if its organization or rules do not comply with the Exchange Act, as

amended. The Commission is authorized, on and after 180 days following receipt of such notification, to suspend the registration of any such exchange or association, or to impose limitations on its activities, functions, or operations if the Commission finds, after notice and opportunity for hearing, that its rules or organization still fail to conform to the Exchange Act. Any such suspension or limitation continues in effect until the Commission, by order, declares that such exchange or association is in compliance with the requirements of the Exchange Act.

Late in 1976, the Commission completed a review of those exchanges rules not addressed in the first set of notices provided to the exchanges in early 1976.[145] This review required a substantial effort by the Commission and its staff and covered all phases of the exchanges' and the NASD's regulatory programs as set forth in their rules. On December 1, 1976, the Commission provided notice to each exchange and to the NASD[146] that generally described the types of exchange and NASD rules, and identified specific rules,[147] that appeared to be inconsistent with specified parts of the Exchange Act.

The December notice isolated over 1,000 rules of the exchanges and the NASD, out of a total of several thousand, covering a broad range of regulatory matters. In its notice, the Commission discussed generally the relationship between several of those rules and the specific standards of the Exchange Act. For example, a number of exchange rules prohibit specialists from dealing directly with institutions, and may thus sanction unfair discrimination between dealers or customers without any corresponding justification in terms of the purposes of the Act. Other questioned rules relating to trading practices appear to accord undue preference, in the execution of orders, to large orders and may unfairly discriminate among customers.

In addition, the Commission expanded its inquiry with respect to rules governing membership and association with member organizations. The Commission, for example, raised questions with respect to (1) restrictions on access to communications systems operated by the exchanges and on access to the NASDAQ system, which is owned and managed by the NASD; (2) the extent to which the composition of governing boards and committees of the exchanges and the NASD complied with the statutory standard of fair representation; and (3) the absence of procedural safeguards in connection with certain exchange and NASD proceedings.

In the December notice, the Commission also questioned exchange rules which did not appear to foster cooperation and coordination with persons engaged in regulating, clearing, settling and facilitating transactions in securities and which may impose unwarranted burdens on competition. The rules of several exchanges, for example, tie contracts governing the clearance and settlement of securities transactions to the rules of clearing agencies affiliated with those organizations, even though members of such organizations might prefer to select other clearing agencies. In addition, the Commission cited rules affecting the processing of securities transactions which appeared to contravene certain provisions of the Exchange Act, including a provision designed to foster competition among brokers and dealers, clearing agencies and transfer agents. These rules may have impeded the development of efficient methods of clearance and settlement by discouraging technological innovation.

The Commission requested and generally has received preliminary presentations by each exchange and the NASD with respect to the rules questioned in the December notice.[148] In those presentations, the exchanges and the NASD addressed the extent to which amendments to their rules have been, or will be, filed pursuant to Section 19(b) and Rule 19b–4 thereunder. The exchanges and the NASD also indicated that certain questioned rules are, in their opinion, consistent with the Exchange Act or require further study. Following those presentations, the Commission's staff held discussions with the exchanges and the NASD in order to explain in further detail the bases on which rules were questioned under Section 31(b). The exchanges and the NASD have responded, in a few instances, with proposed rule changes under Rule 19b–4.

On September 27, 1977, the Commission, in accordance with Section 31(b), gave further notice and opportunity for hearing to the exchanges and the NASD regarding the transaction completion rules cited in the December notice.[149] Pursuant to that notice, the exchanges and the NASD were requested to submit, within forty-five days from the date of the notice, proposed changes to the transaction completion rules or written data, views and arguments explaining why those rules are in compliance with the Exchange Act.

DISCLOSURE RELATED MATTERS

Advisory Committee on Corporate Disclosure

The Advisory Committee on Corporate Disclosure met for a total of 16 days during its nine meetings between July 1976 and September 1977. It conducted comprehensive questionnaire and interview studies of the primary participants in the corporate disclosure system including: publicly held companies, financial analysts, portfolio managers, registered representatives, information disseminators and individual investors.

Briefly stated, the Committee arrived at the following conclusions about the operation of the corporate disclosure system as relates to investors:

Companies, as the principal source of firm-oriented information, are at the center of the corporate disclosure system. Their willingness (as opposed to their obligation) to provide information is a function of management's perception of the utility of the disclosure to the company and the user, the hard and soft dollar costs associated with the disclosure and the feasibility of communicating the information.

Analysts combine the information provided by companies with industry and macroeconomic data. They provide an interpretation of the information and frequently conclude with a buy-sell recommendation directed to specific portfolio objectives. The interest of analysts and disseminators in particular companies is influenced by the company's market capitalization or the potential for unusual return on investment.

Portfolio managers in large structured organizations select industries which will benefit from an assumed economic scenario and utilize analysts' recommendations for individual company selection appropriate to the characteristics of specific portfolios.

Information disseminators condense, summarize and disseminate available information and thereby assist analysts and investors in obtaining investment decision-making information in forms suitable to their respective needs and abilities to use it.

Individual investors use various methods in making investment decisions, ranging from fundamental analysis

and replication of the activities of portfolio managers, to total reliance on the advice of registered representatives.

The Commission administers a mandatory disclosure system intended to assure that reliable firm-oriented information is available to the public. It does not purport to administer a system designed to produce all information used in investment decision-making. Further, information filed with the Commission has often been widely disseminated before filing.

The Committee considered the significant studies concerning the functioning of securities markets, theories concerning capital asset pricing and portfolio organization and belief in some quarters that market forces may adequately provide sufficient reliable firm-oriented information, and concluded, with some dissent, that:

(1) The "efficient market hypothesis"—which asserts that the current price of a security reflects all publicly available information—even if valid, does not negate the necessity of a mandatory disclosure system. This theory is concerned with how the market reacts to disclosed information and is silent as to the optimum amount of information required or whether that optimum should be achieved on a mandatory or voluntary basis;

(2) Market forces alone are insufficient to cause all material information to be disclosed;

(3) Commission-filed documents often confirm information available from other sources. The Commission's filing requirements, while often not a source of new information to investors, assure that information disclosed by publicly held companies through many means is reliable and is broadly accessible to the public.

Although not all members agreed unreservedly, the Committee concluded that the disclosure system established by the Congress in the Secruities Act of 1933 and the Securities Exchange Act of 1934, as implemented and developed by the Commission, is sound and does not need radical reform or renovation. The Committee did forward recommendations for significant changes in the Commission's procedures, rules, emphases, and approaches to disclosure problems. The Committee agreed upon recommendations in a dozen major areas. Included among the recommendations are: (1) that the Commission implement a voluntary program for the disclosure of earnings forecasts and other kinds of forward-looking information; (2) that it develop on an industry by industry basis a standardized product line classification for presentation of both dollar and, where appropriate, unit sales of each product line (within a segment) whose total sales comprised a certain percentage of consolidated sales in the previous fiscal year; (3) that it require increased disclosure regarding candidates for and operation of boards of directors in proxy soliciting material and information statements; and (4) that it schedule hearings to examine the possibility and desirability of alleviating the reporting burden on small companies.

These and all other recommendations are fully discussed in the Advisory Committee's Final Report, available November 1977.

Securities Regulation and the Capital-Raising Ability of Smaller Businesses

In early 1977 the Commission began to examine how securities regulation affects the capital-raising ability of smaller businesses. Under an agreement with the Department of Commerce's National Bureau of Standards Experimental Technology Incentive Pro-

gram (ETIP), the Commission's Directorate of Economic and Policy Research is studying the effect of present and proposed policies on small issuers, broker-dealers and other economic agents in the venture capital industry.

The first phase of this effort analyzes the principal rules, regulations and procedures that influence the flow of capital to new or recently established technology-based ventures. This will include investigation of Securities and Exchange Commission Regulation A and Rules 144, 145, 146, 147 and 240 in an effort to determine the costs and benefits of these provisions. The second phase refines and tests the data and models developed through the analyses in phase one so that an approach to monitoring the effects of SEC regulation in venture capital markets can be established. It is anticipated that this experimental project will require two years to complete.

Management Disclosure and Corporate Governance

The Commission has initiated or completed a number of actions dealing with management disclosure and corporate governance. Generally, these issues involve shareholder communications and corporate governance; disclosure of management background information necessary to evaluate the ability and integrity of management; shareholder proposals; and disclosure of management remuneration and perquisites. Certain broad policy aspects of these questions are being considered at public regional hearings conducted by the Commission; however, other actions, discussed below, have also been taken.

Corporate Governance Hearings

On April 28, 1977, the Commission requested written statements preparatory to holding public hearings on the subjects of shareholder communications, shareholder participation in the corporate electoral process and corporate governance.[150] Such statements and hearings are for the purpose of giving the Commission the benefit of the views of interested members of the public in order to assist the Commission in a broad re-examination of its proxy rules. On August 29, 1977, after a review of approximately 140 written statements received, the Commission published the specific issues to be considered at the hearings, which were scheduled to commence on September 29, 1977 in Washington, D.C.[151]

The Commission noted that numerous recent examples of an apparent breakdown in corporate accountability have led informed commentators to question the efficacy of existing methods of corporate governance. The Commission indicated that, while the proxy solicitation process and the Commission's rules governing that process are a central focus of its inquiry, it hoped to receive information concerning means unrelated to the proxy solicitation mechanism to stimulate increased shareholder interest and participation in corporate governance and to improve corporate accountability.

In view of the importance of the issues to be considered and the Commission's desire to make participation easier for potential witnesses, particularly individual shareholders, the Commission has taken the unusual step of scheduling hearings in Los Angeles, California; New York, New York; and Chicago, Illinois, in addition to Washington, D.C. The hearings are being conducted for the Commission by the Division of Corporation Finance. Witnesses scheduled to testify at the hearings include members of Congress, corporations, business associations,

bar associations, attorneys, public interest groups, individual and institutional investors, religious organizations, academics and others.

Issues to be considered in these proceedings include whether the Commission should require additional disclosures in proxy materials relating to socially significant information, including evironmental and equal employment matters, and whether the Commission should amend its rules relating to shareholder proposals. The Commission will also consider the advisability of affording shareholders access to managment's proxy materials for the purpose of nominating persons to serve on the Board of Directors and the advisability of expanding disclosures in the proxy statement relating to the qualifications of director nominees. At the conclusion of these proceedings, the Commission will determine whether to propose amendments to the proxy rules and other applicable rules and whether to recommend legislation to Congress, such as a bill establishing Federal minimum standards for corporate conduct.

Management Disclosure

On November 2, 1976, the Commission proposed for comment various amendments to registration forms under the Securities Act and to registration and reporting forms and the proxy schedule under the Exchange Act.[152] The proposed amendments are intended to provide more meaningful disclosure to investors regarding the backgrounds of the management of publicly held companies and to provide increased uniformity among various disclosure forms.

The proposed amendments would require disclosure about the identity and background of corporate officials and events which the Commission believes are material to an investor's evaluation of the ability and integrity of directors or executive officers. In addition to the information presently required in proxy material, annual reports and various registration forms concerning the identity and background of directors, the proposed amendments would, if adopted, also require disclosure of all directorships held by each director of the issuer in companies which are required to file reports under the Exchange Act or are registered under the Investment Company Act and disclosure of all memberships held by each director on any committees of the issuer's board of directors. The proposals would also amend the items in various forms relating to material events in the background of directors and executive officers to require disclosure of (1) injunctions prohibiting such persons from engaging in any type of business practice; (2) injunctions and consent decrees prohibiting future violations of Federal or state securities laws; and (3) certain civil actions involving violations of such laws.

To provide for more comprehensive information concerning remuneration received by certain officers and directors, the proposals would expand certain disclosure items by requiring presentation of all direct remuneration paid by the registrant and its affiliates. The existing requirements call for remuneration paid only by the issuer and its subsidiaries.

Concomitant with these proposals, amendments were proposed which would conform the disclosure requirements in the applicable forms under the Securities Act and the Exchange Act. The differences among the various registration and reporting forms in the items requiring disclosure of pending legal proceedings would be eliminated. In addition, amendments are proposed to the proxy schedule

which would reconcile the proxy statements and the annual report disclosure relating to corporate officials and other persons. These latter amendments are thought to be necessary because proxy and information statements, along with annual reports to shareholders, are among the most widely read disclosure documents. Since these documents are intended to communicate information to shareholders which may be useful to their exercise of a voice in corporate affairs, the Commission believes that material information on the background of directors and executive officers is particularly relevant and should be set forth in proxy statements and information statements which relate to election of directors.

In this release, the Commission also invited comments on a few areas involving the adequacy of information about persons responsible for corporate management. The Commission announced that it had received recommendations concerning additional disclosure in this area, especially as to remuneration of corporate officers and directors and as to certain transactions of management. As a result, comments were invited on whether additional disclosure should be required about the numerous emerging forms of indirect compensation or "perquisites" now given to management personnel, the various forms of executive compensation plans, and certain transactions of management involving the issuer and its subsidiaries, such as disclosure of loans extended by issuers or any of their subsidiaries which are primarily engaged in the business of lending money.

The comment period for these proposals ended on January 31, 1977.[153] The proposed amendments are being re-evaluated in light of the comments received.

14a–8 Amendments

On November 22, 1976 the Commission substantially amended Rule 14a–8 of the proxy rules, which sets forth the requirements applicable to proposals submitted by security holders for inclusion in the proxy soliciting materials of issuers.[154] The amendments were designed, among other things, to limit certain shareholder abuses that have occurred in the past, broaden the topics that can be covered by shareholder proposals, and formalize certain grounds for omitting proposals that were implied but not specifically stated in the former rule. Included among the revisions were amendments that: (1) limit proponents of shareholder proposals to a maximum of two proposals of not more than 300 words each to an issuer; (2) advance the timeliness requirements applicable to both proponents and managements by 20 days each; and (3) codify a number of past interpretations of the rule by the Commission's staff, including those which have stated that beneficial owners of securities as well as record owners may submit proposals, and that a proposal which may be improper under the applicable state law when framed as a mandate may be proper when framed as a recommendation or request.

Perquisites

On August 18, 1977,[155] the Commission announced its interpretation of the existing disclosure provisions of the securities acts relating to the disclosure of management remuneration. This release was issued for several reasons. During the four or five months preceding the publication of the release, the staff of the Commission received numerous inquiries relating to whether or not various personal benefits received by management from corporations should be in-

cluded within the aggregate remuneration reported in registration statements, reports and proxy and information statements filed by corporations under the securities laws. Some of these questions may have been prompted by the publicity given to recent enforcement cases brought by the Commission which revealed the failure of such corporations to include within the reported remuneration the value of various personal benefits received by members of management. Others may have raised questions because the Commission had asked for comments earlier[156] on whether additional disclosure about perquisites should be required in registration statements and reports.

The Commission emphasized in this release that registrants are required to report in documents filed under the securities laws the amount of remuneration received by officers and directors from the company from all sources, including salary, fees, bonuses and certain personal benefits, sometimes referred to as "perquisites." This does not mean, however, that the Commission believes that all benefits received by management are personal benefits which must be reported. Certain incidental benefits which are ordinary and necessary to the conduct of company business and incidental payments made by the company for items which are directly related to the performance of management's functions at the company plant or offices may not be reportable forms of remuneration. The Commission noted, however, that all payments made by the company for personal benefits received by management which are not directly related to job performance are forms of remueration which should be included within the reported remuneration.

The interpretative release was issued in order to provide some guidance to registrants in this area. The Commission announced, however, that it was aware that some questions may be unanswered by the release. It noted that the staff is available to assist with questions involving the appropriate disclosure of management remuneration and that it will continue to review its interpretation in light of any specific problems or comments brought to the attention of the staff by registrants and interested persons.

Beneficial Ownership

On February 24, 1977 the Commission adopted amendments to existing rules and Schedule 13D and new rules and a Form 13D–5 relating to disclosure by certain beneficial owners of voting securities pursuant to Section 13(d) of the Exchange Act.[157] At the same time, the Commission amended certain of its forms and schedules under the Securities Act and the Exchange Act to require issuers to disclose information regarding certain beneficial owners of their securities.[158]

These amendments and rules were primarily based on the proposals which were published for comment on August 25, 1975.[159] Among other things, they (1) provide a definition of the term "beneficial ownership" for the purposes of Section 13(d) of the Exchange Act; (2) make the disclosure in Schedule 13D acquisition statements more meaningful to investors and the reporting of that information less burdensome to beneficial owners; (3) provide a short form acquisition notice to be used by certain institutional investors and certain employee benefit plans acquiring securities in the ordinary course of their business and not for purposes of control; and (4) provide an exemption from the filing requirements of Section 13(d)(1) for certain underwriters engaging in a registered, firm commitment underwriting.

The amendments to the various registration, reporting and proxy forms require disclosure in such forms, to the extent known by the filing company, of beneficial owners of more than five percent of any class of voting securities and the aggregate amount and percentage beneficially owned by all directors and officers of each class of voting securities of the issuer and, depending on the form, its parent and/or subsidiaries.

All of the rules and forms adopted or amended on February 24, 1977 were originally scheduled to become effective on August 31, 1977. Because of the substantial practical and interpretative questions raised by institutional investors regarding compliance with the new rules as well as objections by institutions as to the exclusion of certain persons from the use of Form 13D–5, the Commission postponed their effective date until April 30, 1978.[160] In addition, the Commission requested public comment with respect to the objections raised by institutional investors in order to assure that its actions were responsive to the public interest.[161] The original comment period on the institutional investor objections was to expire on September 30, 1977; however, upon request, the Commission extended the period to October 31, 1977.[162]

Concurrently with the adoption of rules and amendments on February 24, 1977 the Commission proposed additional amendments thereto concerning areas which had not been specifically subject to public comment in connection with the prior proposals.[163] These proposed amendments would, among other things, (1) deem a person to be the beneficial owner of a security if he has the right to acquire beneficial ownership either within a specified period of time, pursuant to the automatic termination of a trust, discretionary account of similar arrangement, or at any time, if otherwise acquired; (2) make the short form acquisition notice available to certain foreign entities; and (3) require additional information in Schedule 13D acquisition statements concerning the involvement of reporting persons in civil securities violations and the plans of reporting persons relating to extraordinary corporate transactions involving the issuer or its subsidiaries. The Commission intends to coordinate the announcement of its action on these proposals with any action which may be necessary as a result of the objections raised by institutional investors to the rules which are now scheduled to take effect on April 30, 1978.

Tender Offers

On July 21, 1977 the Commission adopted Schedule 14D–1,[164] Tender Offer Statement, which sets forth the disclosure requirements for persons making certain tender offers. Concurrently, existing Rule 14d–1 was amended to implement the filing of the new Schedule and to specify the disclosure items contained therein which are required to be included or summarized in the information published, sent or given to security holders in connection with such tender offers. These actions, which became effective on August 31, 1977, are intended to augment the present statutory requirements by providing necessary disclosure to investors to enable them to make informed decisions in connection with a tender offer.

Schedule 14D–1 contains several new items which are not contained in Schedule 13D (which is now used solely for acquisition statements) and several significant modifications of items which are in Schedule 13D.

These include new Item 3 which requires disclosure of business transactions between the bidder and the subject company during a specified three year period as well as information relating to contacts and negotiations between those parties concerning the tender offer and other specified transactions. Item 4 requires additional disclosure regarding a bidder's source of funds and the bidder's plan to repay any loan used in connection with the tender offer. Item 9 requires disclosure of certain financial information of the bidder if the bidder is other than a natural person and the bidder's financial condition is material to a decision by a security holder of the subject company whether to tender, sell or hold securities being sought in the tender offer.

The adoption of the Schedule is part of the Commission's plan to replace its emergency rules under the Williams Act with a comprehensive regulatory framework with respect to tender offers. The other tender offer proposals which were published for comment with the Schedule in August, 1976[165] have not been withdrawn and certain of these proposals are being revised in response to the comment letters received from the public. Upon the completion of the revisions to these other tender offer proposals, the Commission presently anticipates further rulemaking action.

Guide 61 - Banks

On August 31, 1976, the Commission authorized the publication of Guides 61 and 3, "Statistical Disclosure by Bank Holding Companies" of the Guides for the Preparation and Filing of Registration Statements under the Securities Act and of the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Exchange Act, respectively.[166] These Guides are intended to provide registrants with a convenient reference to the statistical disclosures sought by the staff of the Division of Corporation Finance in registration statements and other disclosure documents filed by bank holding companies.

As the operations of bank holding companies have diversified, it has become increasingly difficult for investors to identify the sources of income of such companies. And, since various sources of income can have a wide range of risk characteristics, investors may have difficulty assessing the future earnings potential of a bank holding company without detailed information concerning the company's sources of income and exposure to risks.

In the preparation of the Guides, the staff has been mindful of the investor's need to assess uncertainties, the need for disclosure with respect to changes in risk characteristics, and specifically the need for substantial and specific disclosure of changes in risk characteristics of loan portfolios. Accordingly, the Guides call for more meaningful disclosure about loan portfolios and related items in filings by bank holding companies. In addition, many of the disclosures suggested by the Guides are intended to provide information to facilitate analysis and comparison of sources of income and exposure to risks. This information also will assist investors to evaluate the potential impact of future economic events upon a registrant's business and earnings and to assess the ability of a bank holding company to move into or out of situations with favorable or unfavorable risk/return characteristics.

The Commission intends to monitor the experience of registrants and users of the information provided pursuant to the Guides to determine, by June 30, 1978, whether the disclosures

sought by the Guides are necessary and appropriate in the public interest and for the protection of investors. In implementing this monitoring program, the staff will survey and interview potential users of the information including investors, analysts and academicians in order to assess the benefits derived from disclosures provided pursuant to the Guides. The staff also will survey registrants in order to determine what additional burdens and expenses, if any, are incurred in complying with the Guides.

Proposed Form S–16 - Primary Offerings

On December 20, 1976, the Commission announced that consideration was being given to amending Form S–16 to make it available for certain primary offerings.[167] Form S–16 is a registration form which is comparatively simpler and shorter than other available registration forms. Generally, the form is now available for the registration of certain securities of issuers subject to and in compliance with the reporting requirements of the Exchange Act for a period of 36 calendar months and having a net income of at least $250,000 during three of their most recent four years, provided (1) the securities are being offered for the account of persons other than the issuer and securities of the same class are already listed and registered on a national exchange or are quoted on the automated quotation system of a national securities association or (2) the securities are to be offered by the issuer upon conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer. The Commission invited comment on several factors which were intended to limit the type of issuers which would be permitted to use the short form for primary offerings, the kinds of securities which could be registered on the form, and the need for and possible content of additional disclosure items relating to the direct offering.

Upon consideration of the comments and the recommendation of the Advisory Committee on Corporate Disclosure relating to the integration of the Securities Act and the Exchange Act through the availability of the Form S–16 to certain registrants generally classified as Level 1 registrants, the Commission determined on November 1, 1977, to publish for comment specific amendments to the Form S–16 which would expand the availability of the form to certain primary offerings.[168] As proposed, the form would be expanded[169] to permit the registration of[170] (1) securities being offered to the public for cash by certain issuers about which information is widely disseminated among the investing public; and (2) securities being offered by issuers eligible to use the form to existing shareholders through either rights offerings or dividend or interest reinvestment plans. Criteria are proposed which are intended to assure that the protective mechanism of the full registration process is unnecessary because of the availability to the offerees of adequate information about the issuer and the suitability of the terms of the offering for the abbreviated disclosure required by the Form S–16.

Comments were requested on the following criteria for the eligibility of the form for the registration of securities offered in primary offerings: the issue has one or more classes of voting securities held by non-affiliates and has an aggregate market value of $50 million or more and/or 25,000 security holders and/or there is a certain volume of trading in the issuer's securities; the offering is pursuant to a firm

commitment underwriting; and any offering of debt securities is pursuant to a trust indenture subject to and qualified under the Trust Indenture Act of 1939. Certain foreign private issuers would be permitted under these amendments to register securities offered pursuant to rights offerings; and closed end management investment companies would be permitted to register on the Form S–16 securities being offered under Dividend on Interest Reinvestment Plans.

Inasmuch as a prospectus prepared pursuant to Form S–16 is only required to contain very limited information concerning the identity of the issuer or the selling security holders and the plan of distribution, the proposed amendments to the form include proposals to require additional disclosure in the Form S–16 about the use of the proceeds of the offering; the terms of the securities unless the securities are of the same class which is registered under Section 12 of the Exchange Act; and certain other information. Further, issuers using the form for primary offerings would be required by other proposed amendments to undertake to provide without charge to all offerees upon their request copies of any and all of the documents incorporated by reference except that the issuer may charge reasonable costs for exhibits to such documents.

In addition, the proposals include amendments which would: (1) incorporate the long-standing staff practice of allowing the form to be used for resales of securities by underwriters who acquire securities of an issuer in connection with the issuer's call for or redemption of convertible securities; (2) amend the instructions as to required exhibits to include any underwriting agreements or arrangements in connection with the subject offering; (3) require the presentation in the prospectus of information about material recent events which were not disclosed previously in periodic reports filed pursuant to the Exchange Act; and (4) clarify the existing requirement that the consent of experts who are named in any of the documents incorporated by reference or whose reports are used in connection with such documents must be filed with the registration statement or by amendment if the expert is named in material incorporated in the future.

The Commission believes that these amendments, if adopted, will reduce the cost to and simplify the procedures for issuers making primary offerings of their securities. It is believed that investor protection should be served adequately by the criteria proposed for the eligibility of issuers. Nonetheless, the Commission's paramount responsibility is investor protection and safeguarding the public interest in connection with sales and purchases of securities. Therefore, the proposals are being considered on an experimental basis; and, if the amendments are adopted, the broadened usage of the form will be monitored closely to determine the consistence of this usage with the disclosure goals of the Securities Act.

Segments

The Commission published for comment proposed amendments to certain disclosure forms, schedules and rules relating to industry and homogeneous geographic segment reporting.[171] This action is intended, in part, to avoid duplication of financial information as a result of the issuance in December, 1976 by the Financial Accounting Standards Board (FASB) of the Statement of Financial Accounting Standards No. 14, "Financial Reporting

for Segments of a Business Enterprise" (SFAS No. 14). These proposals will also partially implement certain recommendations made by the Advisory Committee on Corporate Disclosure.[172] The Commission also proposed the development of a new, integrated disclosure form, Form S–K. Form S–K should improve and simplify significantly the disclosure process by eliminating immaterial differences among the disclosure requirements in various registration and reporting forms.

SFAS No. 14 requires corporations to disclose revenue, profitability and identifiable assets information by industry and homogeneous geographical segments. Other related disclosures as to the industry segments are also required.

The Commission's principal forms for registration under the Securities Act (Forms S–1, S–7) and for reporting (Form 10–K) and registering (Form 10) under the Exchange Act require the presentation of line of business and foreign operations information which parallels in part the information required by SFAS No. 14. Therefore, amendments were proposed to avoid any duplication and to integrate the two disclosure provisions. The proposed amendments would revise the present reporting requirements to refer to industry segments in lieu of lines of business and to require disclosure of the amounts of identifiable assets, revenue from intersegment sales or transfers, and related matters in addition to the revenue and profitability information now required as to lines of business. Registrants would be required to present this information together with reconciliations of the amounts of revenue, operating profit and identifiable assets to the related amounts in the consolidated financial statements of registrants. In addition, the proposals would require the presentation of revenue, profitability and identifiable assets information as to foreign and domestic operations together with the appropriate reconciliations to related consolidated amounts and disclosure of the amount of export sales.

The Commission forms presently require disclosure of financial information relating to lines of business for a period of five years and accordingly the proposed amendments would require the presentation of financial information relating to industry segments for five years. SFAS No. 14, however, is only applicable to "complete" financial statements and the Commission forms require the inclusion of "complete" financial statements for at most 2 fiscal years. The Commission has invited comment therefore, on whether the proposed industry segment reporting requirement should apply only retroactively.

Five year financial information as to foreign and domestic operations, including the amount of export sales, would also be required by the proposed amendments for the purpose of year to year comparison. This information, however, would be required only for fiscal years beginning after December 15, 1976.

The proposed amendments include provisions intended to assist registrants in identifying industry segments. These provisions are substantially similar to portions of SFAS No. 14. The proposed amendments differ from SFAS No. 14 in two ways: financial information relating to a dominant industry segment would be required by the proposed amendments if the segment is or was experiencing a decline in sales or market share and/or profitability during either of registrant's most recent two fiscal years; in addition, information relating

to the pricing and recipients of intersegment and intra-enterprise sales or transfers would be required.

Amendments were also proposed which would require the presentation of the segment financial information in annual reports to shareholders and in certain proxy and information statements.

Finally, amendments were proposed which would implement the recommendation of the Advisory Committee that the Commission take action to integrate the textual disclosure required in Commission forms with the segmented financial statement disclosures required by SFAS No. 14. These amendments would require registrants to focus upon the industry segments in the description of business called for by Forms S-1, 10 and 10-K. The Commission also invited comments on the Advisory Committee's recommendation that segmented financial statement disclosure be required in interim reports on Form 10-Q.

Projections

On April 23, 1976, the Commission published for comment proposed Guides 62 and 4, "Disclosure of Projections of Future Economic Performance,"of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933 and of the Guides for the Preparation and Filing of Reports and Proxy and Registration Statements under the Securities Exchange Act of 1934, respectively.[173]

The proposed Guides set forth the views of the Commission's Division of Corporation Finance on the disclosure of projections in Commission filings. In particular, the Guides address three important considerations related to the preparation and disclosure of projections: (1) that management have a reasonable basis for its projections; (2) that the projections be presented in an appropriate format; and (3) that the accompanying disclosures facilitate investor understanding of the basis for and limitations of projections.

In announcing the proposed Guides, the Commission indicated that it is not encouraging the making or filing of projections because of the diversity of views on their importance and reliability but noted that the reliability issue, together with the question of whether a "safe harbor" rule for projections is needed, may be among those matters appropriately considered by the Commission's Advisory Committee on Corporate Disclosure.

After termination of the comment period, no further rulemaking action was taken on the proposed Guides pending the Advisory Committee's recommendations in this area. At its meeting on February 7 and 8, 1977, the Advisory Committee tentatively agreed to recommend that the Commission actively and generally encourage the publication of management projections of sales and earnings. The Committee proposed that the Commission issue a statement encouraging public companies to disclose projections in filings with the Commission subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith, and be accompanied by an appropriate cautionary statement.

In order to make the issuance of forecasts attractive to managements, the Committee determined that managements should be accorded wide latitude in determining the manner and nature of the forecast. Accordingly, the Committee agreed to recommend that the Commission encourage, but not require, registrants to publish major assumptions underlying pro-

jections, comparisons of previous projections with actual results and management analysis of the variances. The items of information to be forecasted, the time period to be covered by the forecast, and the decision to discontinue forecasting would also be discretionary with management. Third party review would be permitted but not required. The Committee did agree that the Commission should require previously issued projections still current at the time a registration statement is filed to be included in the registration statement with appropriate updating if necessary.

The Division will consider proposed Guides 62 and 4 in light of the Advisory Committee's recommendations upon issuance of the Advisory Committee's final report.

Industry Guides - Rails

On April 28, 1977 the Commission solicited public comment to assist it in the development of guidelines to be followed by Class I Railroads in the preparation of Securities Act and Exchange Act disclosure documents.[174] The Commission selected Class I Railroads for guidelines formulation, in part, because of the impact of the Railroad Revitalization and Regulatory Reform Act of 1976.[175] This action was also in futherance of a recommendation of the Advisory Committee on Corporate Disclosure that the Commission adopt disclosure guides applicable to particular industries which are designed to encourage uniform textual and financial statement disclosure of material items that are unique to particular industries.

Among other areas, commentators were requested to consider guidelines with respect to: (1) line of business reporting, (2) the status of physical plant and equipment, (3) the average return on invested capital, (4) competitive conditions and position, and (5) disclosure of deferred maintenance.

The Commission also recognized that deferred maintenance is a phenomenon facing a substantial portion of the railroad industry. Accordingly, the Commission requested comment on the development of a uniform definition of deferred maintenance, uniform methodology for its quantification and the appropriate standards of disclosure for such amount under the Federal securities laws.

Because of the substantial differences of opinion on the appropriateness of betterment versus depreciation accounting for purposes of financial reporting by railroads, the Commission also invited comment as to whether betterment accounting should continue to be an acceptable accounting principle for railroads for reporting their financial position in filings with the Commission and in reports to shareholders.

The original comment period on these issues was to expire on June 17, 1977; however, upon request, the Commission extended the period to September 16, 1977.[176] The staff of the Division of Corporation Finance and of the Office of the Chief Accountant are currently conducting a review and analysis of the letters of comment as well as other materials developed internally.

Industry Guides - Electric and Gas Utilities

On May 10, 1977, the Commission announced its intention to develop guidelines for the disclosure to be included in registration statements and reports filed by electric and gas utility companies under the Federal securities regulations.[177] The decision to develop industry guidelines for this industry represents another step in the Commission's undertaking to imple-

ment the recommendation made by the Advisory Committee on Corporate Disclosure[178] that the Commission develop on a limited experimental basis disclosure guides for specific industries in order to encourage uniform textual and financial statement disclosure of material items which are unique to a particular industry.

The guidelines would not constitute Commission rules nor would they bear the Commission's official approval, rather, they would represent policies and practices followed by the Division in administering the disclosure requirements of the Federal securities laws. Generally, their format will be similar to that of the disclosure guidelines for the bank holding company industry.

The electric and gas utility industry was selected as one of the industries for guideline development because of the high demand of the industry for capital, the unavailability to this heavily regulated industry of current pricing adjustments for carrying through to customers increased expenses, and their ever-increasing needs for energy.

Users and preparers of information relating to electric and gas utility companies were invited to comment. The release mentions certain matters which may be appropriate for disclosure development and invites comments on these matters.

The comment period on the proposals expired on September 15, 1977.[179]

Repeal of Form 12–K, etc.

Pursuant to Section 13(b) of the Exchange Act, the Commission is granted authority to, among other things, prescribe the appropriate accounting methods to be used by registrants filing reports with the Commission. Section 308(b) of the Railroad Revitalization and Regulatory Reform Act,[180] as enacted on February 5, 1976, significantly amended and expanded this authority. As amended, Section 13(b) no longer specifically requires that the Commission allow ICC regulated carriers to file reports submitted to the ICC in lieu of the information specified by other Commission forms. In addition, Section 13(b) now provides that Commission rules applicable to registrants whose methods of accounting are prescribed by other laws or regulations may be inconsistent with the disclosure requirements of the other agencies to the extent that the Commission determines that the public interest or the protection of investors so requires.

On September 3, 1976 the Commission proposed to exercise its expanded authority under Section 13(b) and published for comment proposed amendments to Rules 13a–13, 14a–3, 14c–3 and 15d–13 and the revocation of Rule 13b–1 and Form 12–K.[181] These amendments were designed to require that those registrants regulated by the ICC, FPC, and CAB which currently file copies of annual and quarterly reports submitted to their respective agencies in lieu of Commission Forms 10–K and 10–Q instead file reports in compliance with Forms 10–K and 10–Q and the regulations governing such reports.

After review of the comment letters received and further consultation with interested government agencies, the Commission on April 28, 1977 adopted the September proposals substantially as proposed with the result that registrants reporting to the ICC, FPC, FCC and CAB must now file on Commission Forms 10–K and 10–Q for periods ending on or after October 1, 1977.[182]

During this proceeding it was also suggested by a number of railroad commentators that lessor and switching

company railroads should be the subject of a broad exemption from the financial statements requirements of Forms 10–K and 10–Q[183] In connection with its adoption of the September proposals, the Commission announced that it was considering the formulation of rules and requested public comment regarding the appropriateness of providing such an exemption.[184]

Based on its review of the public comment received, especially the fact that relatively few issuers would be within the scope of any exemptive rule of the type considered by the Commission, the Commission determined and announced on October 5, 1977,[185] that it was no longer considering the proposal of a general exemptive rule and that such matters would be most appropriately considered in the context of applications for exemption filed under Section 12(h) of the Exchange Act.[186]

INVESTMENT COMPANIES

The Division of Investment Management is responsible for the administration of the regulatory provisions of the Investment Company and the Investment Advisers Acts of 1940, and performs certain functions relating to disclosure requirements applicable to investment companies and certain similar types of issuers. For possibly the first time since the enactment of the Investment Company Act, the Division is undertaking a comprehensive review of each of the provisions of this statute and of related legislation. The study will seek to identify instances of overregulation, remedy legislative gaps and examine certain entities now excluded from coverage to determine the appropriateness of comparable regulation.

Bank Study

Section 11A(e) of the Exchange Act, added by the Securities Acts Amendments of 1975, authorizes and directs the Commission to study the extent to which banks maintain accounts on behalf of public customers for buying and selling securities registered under Section 12 of the Exchange Act and whether the exclusion of banks from the Exchange Act definitions of "broker" and "dealer" are consistent with the protection of investors and the other purposes of that Act. Section 11A(e) also directs the Commission to report the results of its study, together with such recommendations for legislation as the Commission deems advisable, to the Congress by December 31, 1976.

The major categories of bank securities services considered as part of the Bank Study are: (1) brokerage-type services, such as dividend reinvestment plans, employee stock purchase plans, automatic investment services and customer transactions service; and (2) certain aspects of bank investment management and advisory services, such as advice and assistance to corporate issuers in connection with private placements or mergers, acquisitions and divestitures. Since only limited public information concerning those services was available, the staff prepared a Bank Study Questionnaire and pre-tested it on a sample of potential bank respondents. Thereafter, the Bank Study Questionnaire was submitted to the General Accounting Office for approval pursuant to the Federal Reports Act. Following General Accounting Office approval, the Questionnaire was sent to a statistical sample of 261 banks and trust companies. Also, since much of the necessary factual information regarding these bank securities services was not susceptible to collection through a questionnaire, interviews were commenced with bank officials

and with representatives of securities firms offering comparable services.

In the course of the study, the Commission submitted to the Congress three Reports on Bank Securities Activities. The Initial Report presented detailed factual and statistical analyses of four bank-sponsored brokerage-type services which are similar to services offered by broker-dealers. The Second Report set forth the comparative regulatory framework relating to banks and broker-dealers in offering and operating each of the four services from the point of view of investor protection. The Final Report examined the corporate financing services and trust department securities trading activities of banks. The Final Report also included the Commission's conclusions and recommendations for legislation regarding all of these bank securities activities.

Although the Commission concluded that eliminating the exclusion of banks from the definitions of "broker" and "dealer"in some respects would result in duplicative and unduly burdensome regulation, the Commission established that some bank brokerage and investment management activities are not subject to an entirely adequate regulatory structure. Such documentation reinforced a number of concerns raised by earlier Congressional hearings on bank securities activities. In addition, the Commission's study identified regulatory disparities which, unless corrected, may result in undetected securities law violations resulting from bank securities activities.

The Commission, in its Final Report, submitted to the Congress specific recommendations, to enhance those basic investor safeguards currently unavailable to bank customers and to prevent regulatory disparities from recurring with the passage of time. Those recommendations have been incorporated into S.2131, which was introduced by Senator Williams on September 22, 1977.

Distribution Costs

A matter of chief concern to the Division of Investment Management has been the question of whether investment companies should be permitted to use their assets to pay for advertising, dealers' compensation and other expenses associated with the distribution of shares. In November of 1976 the Commission held public hearings to gain the benefit of the views of interested members of the public, including the industry, with respect to this matter.[187] The hearings were designed to assist the Commission in its consideration of the legal question of whether it is legal under any circumstances for a mutual fund to bear distribution expenses, directly or indirectly, and whether, and to what extent, the Commission presently has authority to permit, prohibit, or limit the use of mutual fund assets to finance various costs of distribution. Also, views were sought on the policy question of whether such use of fund assets would be in the public interest, assuming this is, or could be made, legal. At the close of the fiscal year, the Division was continuing to evaluate the information provided by the hearings.

Variable Life Insurance

In December 1975, the Commission announced a proposal to adopt Rule 6e–2 under the Investment Company Act, which would exempt separate accounts formed by life insurance companies to fund certain variable life insurance contracts from the registration requirements of the Act on the condition that such separate accounts comply with all but certain designated provisions of the Act. The due date

for comments was extended until March 31, 1976.

A variable life insurance contract differs from a traditional whole life insurance policy principally because the death benefit under the contract may or may not increase based upon the performance of a separate account of securities in which a portion of the fixed premiums has been invested. Moreover, the insured accepts the investment risks that the cash surrender value of his policy will be higher or lower than it would otherwise be under a traditional life insurance policy, since this value also reflects the performance of the separate account.

The proposal of Rule 6e–2 followed the granting of an application in October 1975 for an order of exemption from certain provisons of the Act filed by Equitable Variable Life Insurance Company (EVLICO), the Equitable Life Assurance Society of the United States, and EVLICO's separate account, which is registered under the Act as an open-end management investment company. On October 18, 1976 the Commission announced the adoption of Rule 6e–2 essentially as proposed.[188]

At the same time, in response to comments received on proposed Rule 6e–2, the Commission announced the adoption of Rule 6c–3, which provides exemptions for separate accounts which meet the requirements of Rule 6e–2, but which choose to register, under the same terms and conditions as non-registered separate accounts.

Brochure Rule

On July 21, 1977, the Commission published for comment proposed Rule 204–4 under the Investment Advisers Act[189], which would require registered investment advisers to furnish their clients and prospective clients with written disclosure statements containing certain specified information, and to maintain a copy of such written statement as part of their books and records. It was the Division's feeling that, in the absence of such a requirement, clients and prospective clients of registered investment advisers may not receive certain information which would assist them in evaluating and comparing advisory firms. At the same time the Commission announced proposed revisions in Form ADV, the registration form under the Investment Advisers Act, and a proposed new Form ADV–S which would serve as an annual update for all registered investment advisers.[190]

The proposals are designed to provide the Commission with more information than is presently available about a fast growing industry. The number of registered advisers has increased by almost 25 percent in the past year. Because the advisory industry is so large and diverse, the Division staff received many responses to its requests for comments on these proposals and the matter is under active consideration.

E. I. Du Pont de Nemours & Co. et al. v. Collins et al.

On June 23, 1976, the Court of Appeals for the Eighth Circuit, one Judge dissenting, set aside a Commission order which granted a joint application by E. I. Du Pont de Nemours and Company and Christiana Securities Company for an exemption from the Investment Company Act which would permit the proposed merger of the two companies. Application for a rehearing en banc was denied on February 27, 1976. The Supreme Court, however, granted the Commission's petition for certiorari.

On June 16, 1977 the Supreme Court held that the Commission reasonably exercised its discretion under

Section 17(b) of the Investment Company Act in approving the merger of a closed-end investment company, 98 percent of whose assets consisted of Du Pont Co. common stock, into an affiliated company, Du Pont. The court found that the record before the Commission reveals substantial evidence to support the findings of the Commission and the Commission's conclusions of law were based on a construction of the statute consistent with the legislative intent.[191]

ENFORCEMENT

Significant Cases Involving Securities Acts

SEC v. Advance Growth Capital Corporation et. al.[192]—The United States Court of Appeals for the Seventh Circuit affirmed a district court's refusal to vacate a permanent injunction that had been entered in a Commission enforcement action.

Appellants, the two individual defendants in the action, had been permanently enjoined, on April 9, 1973, from engaging in certain conduct which would constitute violations of the Investment Company Act. On a writ of mandamus, the Court of Appeals had directed the district judge to enter a permanent injunction that had been drafted by the Commission's staff.

Twenty-seven months later, the appellants moved to vacate the injunction under Rule 60(b)(5) of the Federal Rules of Civil Procedure, which authorizes a district court to grant relief from a final judgment, *inter alia*, when "it is no longer equitable that the judgment should have prospective application . . . ." In support of their motion, they asserted, *inter alia*, that they had (1) complied with provisions of the Investment Company Act; (2) suffered embarrassment as a result of being enjoined; and (3) been denied the right to participate in the management of Advance Growth Capital Corporation. The district court denied the motion on the ground that is lacked jurisdiction to modify or vacate the injunction without direction from the court of appeals.

Although the court of appeals found considerable authority to the effect that a motion in the same case for relief from a judgment entered pursuant to appellate mandate cannot be entertained by the trial court without appellate leave, it indicated that it would probably not go so far as to hold that appellate leave is necessary whenever relief is sought under Rule 60(b)(5).

The court of appeals affirmed the motion to vacate on the merits on the ground that any relief granted on the basis of the facts alleged in the motion would have been error since the defendants had made no showing that they were suffering a grievous wrong as the result of new circumstances that were not forseen at the time the injunction was entered.

SEC v. Arthur Lipper Corp. and Arthur Lipper, III.[193]—In this case the Court of Appeals for the Second Circuit affirmed the Commission's findings that Arthur Lipper III and Lipper Corporation had aided and abetted violations of the Federal securities laws by engaging in a fraudulent scheme whereby the investment adviser to a complex of mutual funds defrauded those funds and their shareholders of over $1,450,000. Mr. Lipper and Lipper Corp. facilitated this scheme by charging the funds excessive commissions for executing securities transactions in the United States over-the-counter markets and then funnelling 50 percent of those commissions to a subsidiary of the funds' investment adviser. In view of such conduct, the Commission had determined it to be in the public interest to revoke Lipper

Corporation's broker-dealer registration and to bar Mr. Lipper from future association with any broker or dealer. The court of appeals, however, viewed such sanctions as "too severe" and stated that, under the "special circumstances" of this case, selection of those sanctions constituted an abuse of discretion. As a consequence, it then "limited" the sanctions to suspension of Lipper Corporation's registration for 12 months and the barring of Mr. Lipper from association with any broker or dealer for the same period. The Commission filed a petition for a *writ of certiorari* on August 19, 1977.

SEC v. World Radio Mission[194]—On January 16, 1976, the Commission filed a complaint alleging that World Radio Mission (WRM), a religious organization, and Clinton D. White, president of WRM, were violating the anti-fraud provisions of the Federal securities laws by selling securities, in the form of notes and loan plans, to the public while misstating and omitting to state material facts. The district court subsequently denied a motion by the Commission for preliminary relief holding that in light of the First Amendment considerations involved, the Commission was not entitled to preliminary relief since it had failed to establish that irreparable harm to the public would result from the denial of the requested preliminary relief.

On appeal the Commission argued that the district court erred in requiring it to establish irreparable injury to the public, urging that while the Free Exercise Clause protects religious practices it does not immunize fraud.

In response to the defendants' arguments that the Commission had failed to establish an intent to deceive, the Commission argued that the holding in Ernst & Ernst v. Hochfelder,[195] that a private action for damages under Rule 10b–5 may not be based on simple negligence, was not applicable to this action for injunctive relief brought by the Commission and based on violations of Section 17(a) of the Securities Act, as well as Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.

The Court of Appeals for the First Circuit agreed with the Commission, holding that: "From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendants' state of mind is irrelevant."[196] The court also rejected the argument that defendants' sale of securities was protected by the First Amendment, noting that Congress had not exempted the securities of religious organizations from the anti-fraud provisions of the Federal securities laws.

SEC v. Petrofunds, Inc., et al.,[197]—In this case the district judge denied defendants' demand for a jury trial but, pursuant to 28 U.S.C. 1292(b), certified for immediate appeal the question of whether they were entitled to a jury trial in an action where the Commission sought injunctive and ancillary relief, including an accounting and disgorgement to investors of illicit profits.[198] Petrofunds and certain other defendants, with leave of the court of appeals, took an interlocutory appeal from that order., Subsequently, the court of appeals, after considering the Commission's motion, dismissed with prejudice the appeal for failure of appellants to prosecute it.[199]

In denying the defendants' demand for a jury trial, the district judge rejected defendants' argument that the Commission "stands in the shoes of private litigants with respect to its claims for ancillary relief," because the purpose of a Commission enforcement action is to safeguard the public interest by enjoining violations of

the Federal securities laws.[200] Accordingly, he held that the relief sought by the Commission "springs out of the policy of public enforcement of the provisions of the securities laws and exists as an exercise of the equity powers of the Federal court" and "cannot fairly be analogized to any form of relief available at common law."[201] He noted, however, that the case apparently raised for the first time the issue "whether defendants in an SEC enforcement action are entitled under the Seventh Amendment to a jury trial when part of the relief requested is an accounting for, and concomitant disgorgement of, illegal profits,"[202] and thus he certified the question for appeal.

Nassar and Company, Inc. v. SEC[203] —The United States Court of Appeals for the District of Columbia Circuit, in reviewing a Commission order,[204] vacated and remanded that order which had revoked the company's registration as a broker and dealer and barred George M. Nassar from association with any broker or dealer, while affirming a dismissal by the district court of the appellants' related action to have the Commission's order declared null and void.[205] The Commission's order was based on its determination that the evidence before it demonstrated "*** a high pressure sales effort that lasted for a long time, was unsupported by any semblance of an adequate foundation, and was characterized by grossly reckless price predictions."[206] After reviewing the Commission's findings, the court noted the absence of a discussion by the Commission concerning the appropriate mental state required for violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.[207] Accordingly, in deference to its opinion in *Collins Securities Corp. v. Securities and Exchange Commission*,[208] the court remanded the case to the Commission for reconsideration in the light of *Ernst & Ernst* v. *Hochfelder*.[209]

SEC v. American Commodity Exchange, et al.[210]—This action involved thirty-six individual and corporate defendants who were alleged to have engaged in a massive fraudulent scheme in connection with the offer and sale of purported commodity option contracts. The complaint alleged that certain individuals devised a scheme involving the passage of legislation by a state legislature which defined commodity option contracts as securities for purposes of state law, but which exempted from registration those commodity option contracts which were purchased or sold on the floor of a bona fide exchange or board of trade by a broker-dealer registered with the state securities commission. As a secondary step in the scheme, certain individuals undertook to create a commodities exchange which, with the assistance of the then state securities administrator, became the only such exchange in the state. No commodity option transactions ever took place on the floor of the exchange; in fact, the exchange and the clearing house merely served as vehicles for the individuals to collect unearned fees from brokerage houses which were required to join the exchange under threats of reprisals.

The Commission alleged that the purported commodity option contracts constituted "securities" within the scope of the Federal securities laws and that the defendants had violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in connection with the fraudulent offers and sales of such interests.

Of the thirty-six defendants, twenty consented to the entry of Final Judgments of Permanent Injunction with-

out admitting or denying the allegations of the complaint. Default judgments were entered against seven other defendants. The complaint was dismissed without prejudice against two other defendants who were not served. Final Judgments of Permanent Injunction by Summary Judgment were entered against the remaining seven defendants for violations of Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b–5 thereunder. Only one defendant chose to appeal the entry of the injunction against him.

The court of appeals affirmed that district court judgment and held that violations of the antifraud provisions of the securities laws resulted from the scheme involving the creation of the purported exchange and clearing house and the collection of fees for which no legitimate function had been performed. It also stated that the district court correctly held that the purported commodity option contracts, in the circumstances of this case, were investment contracts and thus securities within the Federal securities laws. Further, in its opinion the court of appeals held that the passage of the Commodity Futures Trading Commission Act of 1974 did not strip this Commission of authority to institute this action after the effective date of that Act for conduct which occurred prior to the effective date of that Act. And with respect to the Commission's motion for summary judgment, the Tenth Circuit stated that it was proper for the Commission to submit investigative transcripts in support of its summary judgment motion, since such transcripts "are equivalent to affidavits in terms of the quality of the evidence involved."

Todd and Company, Inc. and Thomas K. Langbein v. *SEC*[211]—On June 27, 1977, the United States Court of Appeals for the Third Circuit, on a petition for review of a Commission order affirming disciplinary action taken by the NASD against a broker-dealer and its president, upheld the Commission's finding that the broker-dealer violated Rules 1, 4, and 18 of Article III of the NASD Rules of Fair Practice. The brokerage firm had created the appearance of a shortage of the stock it was underwriting by refusing to sell the amounts requested by certain of its customers in the initial distribution, and, thereafter, when substantially all the stock was under its control, the firm solicited its customers to buy and sell the stock at substantially increased prices. The court, however, found that procedural errors had been committed by the NASD, and accordingly vacated the Commission's order with instructions that the case be referred back to the NASD.

SEC v. Mor-Film Fare, Inc. et al.[212]—The Commission issued an order directing a private investigation into possible violations of the registration and antifraud provisions of the Federal securities laws by Mor-Film Fare, Inc. and others (appellants). It appeared, from the staff's informal inquiry, that the appellants were selling unregistered securities in the form of interests in limited partnerships and making false and misleading statements concerning, *inter alia*, the cost and value of properties acquired by the partnership, the nature and existence of assets of the partnership and the performance and operations of such properties or assets.

Pursuant to the Commission's order, subpoenas *duces tecum*, were issued to the appellants requiring them to produce relevant books and records of their respective business entities, but the appellants did not fully comply with the subpoenas. Accordingly, the Commission applied to the United

States District Court for the Central District of California for an order to show cause why the appellants should not be compelled to produce the materials requested under the subpoenas. The district court ordered the appellants to comply with the subpoenas and they appealed that order.

The appellants argued before the Court of Appeals for the Ninth Circuit, that the Commission's subpoenas were issued in connection with an unlawfully authorized purpose, sought materials irrelevant to the investigation, were broad and unreasonable, and that the officers of the business entities under investigation could assert their Fifth Amendment privilege against self-incrimination to avert the production of subpoenaed business entity documents.

The Ninth Circuit, in a memorandum opinion, affirmed the district court's order requiring obedience to the subpoenas.

A. J. White & Co. and Allen J. White v. SEC[213]—On June 15, 1977, the United States Court of Appeals for the First Circuit affirmed a Commission order revoking the registration as a broker-dealer of A. J. White & Co., and barring its president, Allen J. White, from association with any broker-dealer.[214] The Commission had found that the broker-dealer and its president had violated the antifraud, extension of credit, record-keeping, and prospectus-delivery provisions of the Federal securities laws in connection with a "best efforts, 65,000 shares or none" underwriting of common stock in Develco Corp. When the broker-dealer became aware that it would be unable to sell the requisite number of shares to investors in bona fide transactions, instead of refunding investors' money it resorted to unusual financing arrangements involving substantial bank loans in the names of one group of individuals being used to purchase stock for the accounts of another group of individuals. The court of appeals affirmed the Commission's finding that the prospectus should have been changed to reflect the changed method of distributing the stock, noting that "[i]f it was too late to disclose the change, the investors had a right to assume that the prospectus would be complied with, not changed."

Handler, et al. v. SEC, et al.[215]—In this case three former officers of Mattel, Inc., sought, among other things, a declaratory judgment voiding portions of a consent decree negotiated in an independent action, *Securities and Exchange Commission v. Mattel, Inc.*, Civ. Action No. 74–2958–FW (C.D. Calif.), which established, among other things, a Special Counsel and Special Auditor to conduct an investigation of Mattel as a result of the reporting violations and other corporate improprieties which had come to the Commission's attention. Plaintiffs instituted this action 15 months after the public dissemination of the reports of the special professionals and over 2 years after the entry of the consent decree. In addition to an order voiding the terms of the consent decree, the plaintiffs sought an injunction prohibiting the defendant's use in any manner of any information or materials compiled by the Special Counsel and Special Auditor.

In granting the Commission's motions, the court found, as the Commission had urged, that it had the power to enforce the consent decree, that there was no unlawful delegation of power from either the district court or the Commission, and that plaintiffs constitutional rights had been, or would be, appropriately protected.

Plaintiffs had challenged the terms of the negotiated consent decrees on the grounds that (1) the entry of the

consent decree judgment and approval of the Special Counsel and Special Auditor contravened the limits of the district court's judicial authority as defined by Article III of the United States Constitution; (2) the judgment represented an unlawful delegation of powers in several respects and was violative of the separation of powers clause of the Federal Constitution; and (3) the judgment unlawfully compromised several of the plaintiffs constitutional rights.

In moving to dismiss the action or, alternatively, for summary judgment, the Commission had argued that the entry of the consent decree judgment was clearly within the scope of the district court's broad equity powers; that plaintiffs misconceived the roles of the special professionals when they characterized them as agents of the Commission and that plaintiffs constitutional rights had been, and would be, appropriately protected.

SEC v. Parklane Hosiery Co.,[216] *Inc.*—In this case, the Court of Appeals for the Second Circuit affirmed the findings of violation made by the district court, but declined to reverse that court and enter a decree of permanent injunction. This action was instituted against Parklane Hosiery Co., Inc. and Herbert Somekh, Parklane's chief officer and major shareholder. The Commission had alleged, and the district court found, that Parklane had gone public by selling 300,000 shares of stock to the public at $9 per share. In 1974, because of heavy financial pressure relating to Somekh's personal finances, Somekh concocted a scheme to take Parklane private, at $2 per share. The Commission's complaint alleged, and the district court found, that the proxy statement seeking approval from Parklane's shareholders for the going-private merger was materially false and misleading, since it concealed from the public shareholders of Parklane the facts that: (1) the purpose of the going private transaction was to enable Somekh to discharge his personal debts from Parklane's treasury; (2) Parklane had engaged in negotiations suggesting that a leasehold held by the company might be saleable for an amount which would net Parklane $300,000; and (3) the independent appraisal of Parklane's shares reflected in the proxy statement had been conducted in the absence of relevant information (including items (1) and (2), above).

The defendants noticed an appeal from the district court's decision, arguing that the information was disclosed to the extent it was required to be, that the information not disclosed was not material to investors, and that any violations of the law were irrelevant, since Somekh owned or controlled 72 percent of Parklane's securities, and the shareholders were powerless to stop the merger in any event. The Commission thereupon cross-appealed from that portion of the district court's decision which denied the Commission's prayer for permanent injunctive relief.

In its decision, the court of appeals held that the district judge's conclusions were not clearly erroneous, and that there were material omissions from Parklane's proxy statement. In so holding, the court rejected the defendants reliance on the Supreme Court's decision in *Santa Fe Ind. v. Green,* U.S. (1977), emphasizing that *Santa Fe* was a private action for damages under Rule 10b–5 whereas this case was a Commission injunctive action for violations of the proxy, periodic reporting and antifraud provisions of the Federal securities laws.

Moreover, the court of appeals concluded that in *Parklane*, unlike the situation conceded to exist in *Santa*

Fe, had the shareholders of Parklane been aware of Somekh's reasons for the going-private transaction, they, or others, might well have been able to enjoin the merger under New York law as having been undertaken for no valid corporate purpose. Such a capacity to sue under state law, the court concluded, makes the omissions material, irrespective of Somekh's controlling influence over Parklane.

In re Weis Securities, Inc.[217]—In this case the district court held in enforcing subordinated loan agreements in a broker-dealer liquidation, that customers and creditors need not show actual reliance on subordination agreements, but that reliance on subordinated loans should be presumed as a matter of law. In that case, a number of subordinated lenders sought to rescind their subordination agreements and share in the distribution with customers or with general creditors of Weis on the ground that the subordinated lenders had been fraudulently induced to enter into such loan agreements. Under both Commission and New York Stock Exchange rules, Weis was permitted to treat subordinated loans as part of its capital for the purpose of meeting its net capital requirements.

The Commission argued in the district court and in its brief in the court of appeals,[218] that the Federal policy of customer protection embodied in the Federal securities laws relating to the financial responsibility of broker-dealers, including the net capital requirements, requires that subordinated lenders not be permitted to rescind subordination agreements, even if fraudulently procured, where rescission would adversely affect customer claims. The Commission also took the position that since the remedy of rescission is generally inapplicable in liquidations where, as in *Weis*, the funds or securities with which a creditor has been fraudulently induced to part cannot be traced or identified, to the extent that a subordinated lender has any claim, it could only be a tort claim for fraud. Accordingly, the Commission expressed the view that subordinated lenders could participate in the Weis estate, if at all, only with the claims of non-customer creditors after customer claims have been satisfied.

SEC v. Bausch & Lomb[219]—The United States Court of Appeals for the Second Circuit, determined not to reverse a district court's determination to deny the Commission's application for injunctive and other equitable relief. In the district court, the Commission had alleged that Bausch & Lomb, through its Chairman of the Board, had selectively disclosed material. inside information to a few securities analysts. But, the district court was "*** not convinced *** that absent an injunction there is a reasonable likelihood that defendants will violate the securities laws in the future,"[220] and therefore denied the Commission's prayer for equitable relief. The district court also opined that *scienter* is a necessary component in an action brought by the Commission under Section 10(b) of the Exchange Act and Rule 10b–5.[221] In affirming the judgment below, the court of appeals did not reach the *scienter* question, stating: "We need not now decide whether *Hochfelder*[222] mandates abandonment of our long-standing rule that proof of past negligence will suffice to sustain an SEC injunction action."[223] The court of appeals agreed with the district court that the Commission had not established the necessity for an injunction to prevent future violations and was "*** not inclined to substitute its judgment for that of the experienced trial judge who heard the witnesses and had the 'opportunity by observa-

tion better to prophesy future conduct than we can on this printed record'."[224]

Natural Resources Defense Council, et al. v. SEC[225]—This decision is the most recent development in a six-year effort by several public interest groups to compel the Commission to adopt rules requiring publicly-held companies to disclose non-material[226] information concerning their environmental and employment practices in documents filed with the Commission or distributed to shareholders. The plaintiffs had argued that the Commission was compelled to adopt the disclosure policy they favor by the National Environmental Policy Act of 1969, 42 U.S.C. 4321 *et seq*. The court rejected this contention, but remanded the matter to the Commission for further consideration because of certain "flaws" that it believed marred the Commission's decision-making process, including, *inter alia*, the failure to conduct "cost/benefit" studies, the failure to consider adopting the plaintiffs' suggestions only with respect to proxy disclosures, and the Commission's reliance, in part, on the activities of other governmental agencies. The Commission has taken an appeal to the United States Court of Appeals for the District of Columbia Circuit.

Collins Securities Corp. v. SEC[227]—In this case the Court of Appeals for the District of Columbia reversed and remanded a Commission order revoking the broker-dealer and investment adviser registrations of Collins Securities Corporation and barring Timothy Collins, its principal, from association with a broker or dealer (provided that after two years he could apply to become so associated in a position not directly or indirectly connected to market making activities). The Commission found that Collins Securities Corporation and Mr. Collins had violated numerous provisions of the Federal securities laws, including manipulation of the market for securities of Big Horn National Life Insurance Company.[228]

The court of appeals did not address either the respondents' substantive objections to the Commission's findings of violations of the Federal securities laws or the contentions they made regarding the propriety of the statutorily-authorized sanctions. Instead, after briefly describing the underlying factual setting, the court focused upon the standard of proof applicable in broker-dealer administrative proceeding involving allegations of violations of antifraud provisions of the Federal securities laws. In that connection, the court held that the Commission had erred in basing its decision on the "preponderance of the evidence" standard of proof because the court believed "clear and convincing evidence" is required in administrative proceedings involving charges of fraud, at least where the sanction is expulsion from the securities industry. It thus remanded the matter to the Commission for a reexamination of the entire evidentiary record. Further, in light of the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[229] the court of appeals directed the Commission to consider the applicability of a *scienter* requirement to fraud charges in Commission administrative proceedings.

SEC v. Universal Major Industries Corporation, et al.[230]—In this case, the district court found that Arthur Homans, an attorney, through the issuance of opinion letters asserting the legality of the distribution of nearly 3.5 million shares of unregistered Universal Major Industries Corporation common stock to over 600 individuals, aided and abetted a violation of Section 5 of the Securities Act. The court held that "in some circumstances Homans knew, and in other circumstances had reason

to know, that his client was engaging in illegal distributions of its common stock and that his letters were being used to further those distributions."[231] Having found that the Commission had made a *prima facie* showing of violations of the Federal securities laws, and that there existed a reasonable likelihood of future violations by Mr. Homans, the district court granted the Commission's request for injunctive relief.

Mr. Homans appealed the district court decision to the United States Court of Appeals for the Second Circuit.[232] The Commission, in its answering brief, argued that (1) the offer and sale of Universal Major Industries common stock, under the circumstances described above, was not exempt from registration pursuant to Section 4(2) of the Securities Act; (2) the district court correctly concluded that Universal Major Industries common stock was sold as part of a public offering; (3) aiding and abetting liability could be imposed for Section 5 violations; (4) the *scienter* requirement enumerated in *Ernst & Ernst v. Hochfelder*[233] has no application in an action involving Section 5; and (5) the district court did not abuse its discretion in enjoining Mr. Homans from participating in further violations of the registration provisions of the Securities Act.

The Court of Appeals for the Second Circuit affirmed the district court,[234] finding that under the circumstances of this case, Homans had aided and abetted the public offering of unregistered securities. Moreover, the court rejected Homans' argument that the *Hochfelder* culpability standard was applicable in SEC injunctive actions and found that in proceedings instituted by the SEC seeking equitable relief, the cause of action may be predicated upon negligence alone and that proof of *scienter* is unnecessary.[235]

Sloan v. SEC[236]—In this case Samuel H. Sloan challenged the Commission's authority to issue a series of consecutive summary trading suspension orders, which had suspended trading in the common stock of Canadian Javelin Ltd. on the American Stock Exchange and in the over-the-counter market for consecutive ten-day periods from April 29, 1975 through May 2, 1976. These orders were entered pursuant to the authority conferred upon the Commission by former Sections 15(c)(5) and 19(a)(4) of the Exchange Act[237] and, after the Securities Acts Amendments of 1975 became effective, by new Section 12(k) of the Act,[238] which restated and consolidated the Commission's authority to issue summary trading suspension orders.

In the court of appeals, Mr. Sloan argued, among other things, that the Commission's authority to suspend trading is limited by the statute to "a period not exceeding ten days."[239] The Commission contended that the legislative history of the Securities Acts Amendments of 1964, which added Section 15(c)(5) to the Act, makes clear that Congress had accepted the Commission's practice of issuing consecutive suspension orders at the time that the Commission's summary suspension authority was extended to include securities traded in the over-the-counter market.

The court of appeals held that the Commission's practice of issuing consecutive summary trading suspension orders exceeded the authority conferred upon it by Section 12(k) of the Exchange Act (and former Sections 15 (c)(5) and 19(a)(4) of the Act). In addition, although the review proceeding was not a class action, the court directed the Commission to "discontinue" the practice of issuing consec-

utive ten-day trading suspensions "forthwith."

In May, 1977, the Solicitor General filed a petition for a writ of certiorari in the Supreme Court, on behalf of the Commission, which contends that the court of appeals erred in several respects, particularly in its reading of the legislative history and its determination that the suit had not become moot. The petition was granted on October 17, 1977.[240]

Commission Litigation

SEC v. National Student Marketing Corporation, et al.—Since the date of the last Report, the balance of the Commission's case arising out of its investigation relating to the affairs of National Student Marketing Corporation was either settled or tried. During this period, all but five of the remaining defendants consented to some form of court order. Each of the consenting individual defendants,[241] without admitting or denying the Commission's allegations, consented to the entry of a Judgment of Permanent Injunction against him with respect to certain violations of the Federal securities laws. They did so after the Commission had filed a detailed pretrial brief in December 1976 setting forth the factual allegations involved.

In addition, Marion J. Epley, III,[242] one of the defendants in the action and a partner of the law firm of White & Case, as part of his settlement, agreed in a letter to the Chairman not to practice before the Commission for a period of 180 days. The Injunction against Epley also prohibits him from issuing certain legal opinions under certain circumstances. Further, the Injunction requires Epley to comply with applicable procedures of White & Case regarding representation by the firm of corporations subject to the Federal securities laws.

The law firm of White & Case[243] which was also a defendant, as part of its settlement, agreed to a court Order which enables the court to retain jurisdiction to effect compliance with the terms and conditions of the settlement. The Stipulation of Settlement provides that White & Case "undertakes to adopt, effectuate and maintain procedures in connection with its representation of clients in matters involving the Federal securities laws." A copy of White & Case's procedures was attached to the Stipulation. Among the firm's procedures are provisions concerning the retention of certain new clients, review of certain registration statements by a second partner of the firm experienced in securities matters who is not otherwise involved in the transaction, and identification of certain circumstances involving the issuance of securities to the public where consultation with other partners within the firm is required. Both the Order and Stipulation indicate that the Commission has neither approved nor disapproved of the procedures.

One of the other individual defendants, John G. Davies, had a Default Judgment of Permanent Injunction entered against him by the court.

The trial of the Commission's action against the remaining defendants, Cameron Brown, the law firm of Lord, Bissell & Brook, and its two partners, Max E. Meyer and Louis F. Schauer, began on May 16, 1977. Closing arguments were held in early August 1977. At this time, the Commission is awaiting the decision of the court.

As previously reported, Anthony M. Natelli, the audit partner of Peat, Marwick, Mitchell & Co. responsible for the National Student Marketing account, was criminally convicted of violating the Federal securities laws. In late 1976, following his failure to set

aside that conviction, both by direct and collateral attack, Natelli served a prison term for his conviction.

With respect to the Peat, Marwick, Mitchell & Co. audit supervisor, Joseph Scansaroli, whose conviction, as previously reported, was reversed by the Court of Appeals for the Southern District of New York with a new trial ordered, a settlement was ultimately arrived at[244] which provided that he would not be retried. However, he agreed to the entry of a Permanent Injunction and permanent bar from practice before the Commission under Rule 2 (e) of the Commission's Rules of Practice. This disposition of the case as to Scansaroli was agreed to with the concurrence of the Department of Justice.

SEC v. Royal Industries Inc.—On November 16, 1976, the Commission filed a complaint seeking injunctive relief against Royal Industries Inc. (Royal), a Delaware corporation with its principal executive offices at Pasadena, California.[245] The Commission's complaint alleged that Royal had violated the filing requirements of the tender offer provisions of the Exchange Act in filing with the Commission incomplete and inaccurate statements on Schedule 14D urging rejection of a tender offer for its securities by Monogram Industries Inc. (Monogram).

The complaint further alleged that Royal's Schedules 14D failed to disclose that a principal purpose of Royal's proposed acquisition of SAR Industries Inc. (SAR) was to interpose a potential antitrust obstacle to Monogram's proposed tender offer.

The complaint further alleged that Royal's Schedules 14D filed with the Commission contained statements that Royal's board of directors urged rejection of a proposed tender offer by Monogram, but failed to disclose provisions in Royal's deferred compensation plans for certain employees which provided for acceleration of approximately $9 million of benefits to approximately 100 employees, in the event a 25 percent interest in Royal was acquired in a transaction in which a majority of Royal's board of directors did not concur. The complaint further alleged that Royal failed to disclose that two directors who voted to recommend against Monogram's proposed tender offer were participants in such plans and would receive approximately $1,325,000 in benefits upon acceleration of payments under the plans.

The complaint also alleged that Royal's Schedules 14D contained incomplete and inaccurate statements concerning commissions to be paid to brokers soliciting shares tendered, the obligations of Monogram to accept part or all of the shares tendered, and a financial statement comparison of Royal and Monogram.

The court entered a Judgment of Permanent Injunction against Royal restraining and enjoining Royal from violations of the filing requirements of the tender offer provisions of the Exchange Act. Royal consented to the entry of the Judgment without admitting or denying the allegations of the complaint.

In addition to the entry of the Judgment against Royal, the court ordered certain ancillary relief, including the following:

(1) An undertaking by Royal to adopt, implement and maintain procedures reasonably designed to prevent the recurrence of the activities alleged in the Commission's complaint, or similar activities, and designed to assure compliance with the filing requirements of the tender offer provisions of the securities laws; and

(2) An undertaking by Royal to amend its Schedules 14D filed with the Commission and to correct its statements

to shareholders to assure that such filings and statements are complete and accurate and otherwise comply with the securities laws.

SEC v. American Commonwealth Financial Corp., et al.—On May 12, 1977, the Commission filed a complaint seeking injunctive relief against American Commonwealth Financial Corporation (ACFC), an insurance holding company located in Dallas, Texas, of which Great Commonwealth Life Insurance Co. (GCL) of Dallas, Texas and National American Life Insurance Company (NALICO) of Baton Rouge, Louisiana, were or had been subsidiaries; Centram Industrial Limited (Centram), a Louisiana corporation; First Republic Life Insurance Company (FRLIC), a Louisiana corporation; Corporate Hotel Partnership (Partnership), a Louisiana limited partnership; Mountain, Inc. (Mountain), a Louisiana corporation; Valley, Inc. (Valley), a Louisiana corporation; Rodolfo Jesus Aguilar (Aguilar), a general partner in Partnership and owner of 30 percent of the stock of Mountain, and, directly and indirectly, all of the stock of Centram; Jules Burton LeBlanc, III (Jules LeBlanc), general partner in Partnership, owner of 70 percent of the stock of Mountain and 100 percent of the stock of Valley, and engaged in partnership with Aguilar in real estate development; Paul James LeBlanc (P. J. LeBlanc), director and chairman of the board of ACFC from April 1975 to December 1976; and Roger Jean LeBlanc (R. LeBlanc), president, director and chief executive officer of ACFC from approximately April 1975 through the filing of the complaint, controlling shareholder of ACFC since February 1975, owner of 99.5 percent of the stock of FRLIC, and brother of Jules LeBlanc.[246]

All of the defendants except P.J. LeBlanc consented to the entry of Final Judgments of Permanent Injunction, without admitting or denying the Commission's allegations.

The Commission's complaint alleged that the defendants engaged in a fraudulent course of conduct whereby they used the assets of ACFC and other public companies for their personal gain and benefit and to service debt owed to third parties by various of the defendants.

According to the complaint, prior to February 1975, defendants Jules LeBlanc, Aguilar and to a lesser extent R. LeBlanc had borrowed substantial sums from the Chase Manhattan Mortgage and Realty Trust (CMART), totalling over $25 million by the end of 1974, in connection with real estate development in Baton Rouge, Louisiana. All of the CMART loans were personally guaranteed by R.LeBlanc or Jules LeBlanc and were in default by the end of 1974.

The complaint further alleged that R. LeBlanc, aided and abetted by Jules LeBlanc, P. J. LeBlanc and others, acquired shares of common stock of ACFC so as to control that corporation in order to use its assets for their personal gain and to service the CMART debt.

According to the complaint, in February 1975 R. LeBlanc purchased approximately 28 percent of the common stock of ACFC, representing control of the corporation. In June and July 1975, according to the complaint, R. LeBlanc caused ACFC to sell to him 505,050 shares of the company's common stock at a value of $2 million in consideration for $1 million and real property purportedly worth more than $1,350,000. The complaint alleges that in connection with this additional acquisition of ACFC common stock, R. LeBlanc failed to disclose that the real property involved in the transaction had been acquired by Jules LeBlanc and other members of R. Le-

Blanc's family only three years prior at a price less than $400,000, and that the $1 million in cash for the acquisition of the shares was borrowed from a bank by pledging the ACFC shares which R. LeBlanc acquired in February 1975.

The complaint charged that in order to borrow approximately $3.5 million to repay certain indebtedness, R. LeBlanc pledged about 44 percent of the outstanding stock of ACFC, and, without the knowledge or prior approval of the ACFC Board of Directors, entered into a loan agreement which materially restricted ACFC's ability to conduct certain business, issue stock, increase capital or grant dividends.

The complaint further alleged that in September 1975 R. LeBlanc caused ACFC to purchase from Louis J. Roussel, Jr. (Roussel) and others approximately 56.5 percent of the outstanding shares of common stock of NALICO. ACFC gave to Roussel notes secured by a mortgage on the same property previously transferred to ACFC by R. LeBlanc to secure his own purchase of 505,050 shares of ACFC stock. After Roussel complained that this property was substantially overvalued, R. LeBlanc caused NALICO to purchase the notes from Roussel.

The complaint charged that in late November 1975, R. LeBlanc and Jules LeBlanc, with the assistance of Aguilar, engaged in a series of transactions to utilize the credit of ACFC to assist the Baton Rouge "Corporate Square" shopping and building complex, owned by Jules LeBlanc and Aguilar, in obtaining an extension of the CMART loans on which it and they were in default.

The complaint charged that R. LeBlanc caused FRLIC to engage in certain transactions with publicly-held insurance companies whereby FRLIC contracted to assume certain liabilities of those companies and in exchange acquired assets, including marketable securities, which he thereafter caused FRLIC to liquidate for cash. With this cash, R. LeBlanc caused FRLIC to purchase the notes or stock of various private companies owned and controlled by R. LeBlanc, Jules LeBlanc, or their associates, to disburse large sums of money to such persons, and to guarantee loans to such persons. The complaint alleged that the insurance companies contracting with FRLIC had been relying on FRLIC's ability to discharge its assumed liabilities but that the above transactions had resulted in a material impairment of FRLIC's capital and raised questions about its financial condition.

The complaint further alleged that in 1976 FRLIC, directly and through subsidiaries, acquired 34 percent of the shares of American Public Life Insurance Co. (APLIC), a Mississippi insurance company, and options to purchase a controlling block of shares of United Founders Life Insurance Co. (UFLIC), an Oklahoma insurance company, and in connection therewith, filed false and misleading Schedule 13D information statements with the Commission.

The complaint alleged that there was a close relationship between Louisiana Governor Edwin Edwards and Jules LeBlanc. The complaint further alleged that, at the request of Jules LeBlanc, Governor Edwards contacted the Insurance Commissioner of Louisiana concerning possible regulatory and enforcement action to be taken with respect to FRLIC, after which the Insurance Department deferred such action.

The court entered Judgments of Permanent Injunction on June 30, 1977 against R. LeBlanc, Jules LeBlanc, Aguilar, ACFC, FRLIC, Partner-

ship, Mountain, Valley and Centram, based on consents, enjoining them from violations of the antifraud provisions of the Federal securities laws. In addition, the Court enjoined R. LeBlanc, ACFC and FRLIC from violations of the reporting provisions and R. LeBlanc and FRLIC from violations of the proxy solicitation provisions of the Federal securities laws.

In addition, certain ancillary relief was ordered by the Court, including the following:

1. The Court gave R. LeBlanc nine months within which to dispose of his ACFC stock. In the event that R. LeBlanc failed to do so his stock would be placed in an independent voting trust, the trustee of which would be approved by the Commission;

2. R. LeBlanc was required to resign as an officer of ACFC;

3. ACFC was required to retain a person to act as a monitor over the business affairs of ACFC and to approve all ACFC transactions over $5,000. When ACFC failed to comply with this provision of its Final Judgment, the court, upon petition by the Commission, appointed a monitor on September 7, 1977;

4. FRLIC was required to retain an independent certified public accountant to perform an audit of FRLIC, including affiliated transactions, in the event that the state of Louisiana did not perform a full scale audit of FRLIC within a specified time period; and

5. FRLIC and LeBlanc were restrained from voting for or nominating more than a minority of the Board of Directors of APLIC and UFLIC in order that the Boards of these two companies would remain composed of a majority of persons unaffiliated with R. LeBlanc. APLIC consented to be bound by these provisions of the FRLIC and LeBlanc Final Judgments.

SEC v. National Pacific Corporation et al.—On September 24, 1976, the Commission filed a complaint for Injunctive, Receivership and Other Relief against National Pacific Corporation (NPC), National American Life Insurance Co. (NALICO), a publicly-held company, Great Pacific Corporation (GPC), Family Provider Life Insurance Company (Family), Pacific Southwest Insurance Agency, Inc. (PSIA), Joseph Hauser (Hauser), Melvin Wyman (Wyman), John Boden (Boden), and George Herrera (Herrera), charging violations of the antifraud provisions and certain reporting provisions of the Federal securities laws.[247]

The complaint charged that, between June 1976 and the filing of the action, NALICO, NPC (controlled by defendants Hauser, Wyman, and Boden) and the other defendants made or caused to be made false filings with the Commission and other governmental agencies and misappropriated valuable assets of NALICO.

The Commission alleged that between January and June of 1976, prior to acquiring control of NALICO, the defendants wrongfully appropriated approximately $1 million from insurance premiums paid directly or indirectly to Family by various union health and welfare funds. After the acquisition of control of NALICO, the defendants caused NALICO to purchase from NPC convertible surplus notes of another company, Farmers National Life Insurance Co. (Farmers), which, according to financial statements filed by Farmers, did not have enough surplus to meet the terms of the convertible surplus notes put into NALICO by the defendants.

The complaint further alleged that the defendants caused NALICO to enter into a reinsurance agreement with Family, whereby assets and liabilities of Family were assumed by NALICO. Those assets included $2.2

million in notes which had been cancelled by Hauser in March of 1976 and, consequently, were worthless. The Commission in its complaint further alleged that the documents relating to the above transactions, which were entered into in late June, were backdated to make it appear as if they had been entered into prior to the acquisition of control of NALICO by NPC.

The complaint alleged that financial statements filed by the defendants on behalf of NALICO with various state insurance regulatory agencies as of June 30, 1976 were false and misleading by failing to disclose the above matters. In addition, documents relating to the acquisition of control of NALICO filed with the Louisiana Insurance Department and the Commission (an Information Statement on Schedule 13D) were false and misleading by failing to disclose the same matters.

Following July 15, 1976, according to the complaint, the defendants misappropriated from NALICO approximately $1.5 million, including approximately $100,000 used to pay off debts of the defendants incurred prior to their acquiring control of NALICO and $1.1 million paid to a newly-formed Swiss company.

In addition to seeking injunctive relief, the Commission, in its complaint and in a Motion for Preliminary Injunction filed simultaneously therewith, sought the appointment of a receiver for NALICO, a Louisiana-based, publicly-held insurance company, 58 percent of the common stock of which had been owned by NPC since June 15, 1976.

Upon the Commission's application for a Temporary Restraining Order, U.S. District Judge Gerhard Gesell, on September 24, 1976, issued such an order freezing the assets of all the defendants (except the normal and reasonable living expenses of the individual defendants). On September 29, 1976, upon the Commission's application for a preliminary injunction, U.S. District Judge Charles Richey issued another Temporary Restraining Order and appointed Herbert E. Milstein, Esq., Agent of the Court with authority over the assets of NALICO.

On October 14, 1976, U.S. District Judge William Bryant entered a Final Judgment of Permanent Injunction with respect to defendant Boden, by consent.

On December 2, 1976, Judge Charles Richey entered two Orders and a Stipulation effecting final settlement of this action by consent.[248] The Orders signed by Judge Richey were as follows:

(1) A Final Judgment of Permanent Injunction as to defendant NALICO, whereby NALICO was enjoined from violations of the antifraud provisions of the Federal securities laws, and whereby the court's agent, Herbert E. Milstein, was appointed as Receiver over NALICO, to control and manage the business affairs of NALICO and to prosecute any claims by or on behalf of NALICO.

(2) A Final Judgment of Permanent Injunction as to defendants Hauser, Wyman, Herrera, NPC, GPC, Family and PSIA, whereby all were enjoined from violations of the antifraud provisions; Hauser, Wyman, and NPC were enjoined from violations of the reporting provisions; and defendants Hauser, Wyman, Herrera, GPC, FPLIC, NPC and PSIA, and certain related entities were ordered to file with the court affidavits as to their assets and liabilities, and to cooperate with the Receiver or his successor.

In addition, the following terms, among others, were ordered:

(a) Hauser, for a period of 10 years,

and Wyman, for a period of 5 years were prohibited from serving as directors, officers, or control persons of any publicly-held company, without the prior written approval of the Commission;

(b) Hauser and NPC were ordered to return to NALICO within 10 days the $1.1 million remitted in the name of NALICO to the Swiss company in August of 1976; and

(c) The Receiver was authorized to seek disgorgement from any of the defendants.

In addition to the entry of the Orders, Judge Richey on December 2, 1976 also approved the terms of a Stipulation by and between NALICO, Mr. Milstein and Mr. Sherman A. Bernard, Commissioner of Insurance of the State of Louisiana. Pursuant to this Stipulation, which was also approved by the Commission, the parties to the Stipulation acknowledged the respective interests in NALICO of the Commission and the Insurance Commissioner, who had been appointed Rehabilitator of NALICO by a Louisiana State Court, and consented to the designation of the Agent as Receiver, with full powers of an equity receiver, over NALICO. The parties to the Stipulation further agreed that, among other things, any disputes between the Receiver and the Insurance Commissioner would be submitted to the United States District Court for the District of Columbia for its resolution of such disputes.

With respect to the $1.1 million that the court ordered Hauser to return by December 12, 1976, only $832,000 was initially returned. The Commission and the NALICO Receiver moved to hold Hauser in civil contempt of court for not returning the remaining funds. In addition, the Commission and the Receiver asked the court to hold Hauser in contempt for having used a NALICO credit card to incur $4,530.49 in expenses after the entry of the September 29, 1976 freeze order. The court, on July 7, 1977, adjudicated Hauser in contempt of the December 2, 1976 Final Judgment and the September 29, 1976 freeze order, and ordered Hauser to return the sums of $4,530.49 and $142,000 (the portion of the remainder of the $1.1 million that Judge Richey held Hauser in contempt for not returning) within 30 days.

At a hearing held September 28, 1977 in the U.S. District Court, Judge Richey, after hearing testimony of Hauser, held Hauser in further contempt of his July 7, 1977 Order, ordered that he be incarcerated until he paid to the NALICO Receiver $146, 530.49 and fined Hauser $10,000.

After being incarcerated in the jail in the District of Columbia for approximately one week, Hauser was discharged from confinement when he paid the Receiver $156,530.49.

SEC v. Falstaff Brewing Corporation, et al.,—On May 25, 1977, the Commission filed a complaint seeking permanent injunctive relief against Falstaff Brewing Corporation (Falstaff), a corporation with principal offices in San Francisco, California which engages in the manufacture and distribution of beer and other malt beverages; Paul Kalmanovitz (Kalmanovitz), the current chairman of the board of directors and controlling shareholder of Falstaff; Ferdinand Gutting (Gutting), former president and chairman of the board of Falstaff; and James S. McClellan (McClellan), a former member of the board of directors of Falstaff and counsel to Falstaff.[249] The complaint sought, in addition, preliminary relief against Falstaff, including an injunction against violations of certain provisions of the securities laws pending trial on the merits, and order pro-

hibiting Falstaff from convening its annual shareholders' meeting scheduled for June 7, 1977 and prohibiting Falstaff from soliciting or voting proxies by means of its 1977 proxy statement. McClellan and Gutting consented to the entry of Judgments of Permanent Injunction at the time the complaint was filed.

The complaint charged Falstaff, Kalmanovitz, McClellan and Gutting with violations of the antifraud, proxy and reporting provisions of the Federal securities laws in connection with a 1975 transaction whereby Kalmanovitz acquired 52 percent of the outstanding voting rights of Falstaff. It was alleged, among other things, that Falstaff's 1975 proxy soliciting material failed to disclose that Kalmanovitz would obtain such control; that one-half of his voting rights were obtained in consideration for an extension of credit by one of Falstaff's suppliers; and that certain provisions in the agreement between Falstaff and Kalmanovitz concerning the prepayment of Falstaff's long term debt would violate agreements with Falstaff's lenders which required *pro rata* payment among all such lenders. Falstaff was additionally charged with violations of the periodic reporting provisions of the securities laws in connection with its filings with the Commission from 1974 to 1977. The Commission also alleged that Falstaff's 1977 proxy soliciting material was materially false and misleading with respect to a proposed change in the dividend rights of Falstaff's Class A preferred stock, of which Kalmanovitz owned 100 percent.

On August 1, 1977, after a hearing on the Commission's motion for preliminary relief, Judge Howard F. Corcoran, U.S. District Judge for the District of Columbia, entered a Judgment of Preliminary Injunction and Other Relief against Falstaff enjoining Falstaff from future violations of the antifraud, reporting and proxy provisions of the Federal securities laws. In addition, the court preliminarily enjoined Falstaff from convening its annual shareholders meeting and prohibited the solicitation and voting of proxies by Falstaff in connection therewith. Judge Corcoran, in a lengthy opinion, stated that "The Commission has made a strong *prima facie* showing that there is a reasonable likelihood of future violations of the Federal securities laws on the part of defendant Falstaff...."

Since the entry of the preliminary injunction, Falstaff has filed an appeal which is currently pending before the Court of Appeals for the District of Columbia. Falstaff also made a motion to the district court for clarification and modification of the order of preliminary injunction, which was denied, and a motion to stay the preliminary injunction pending appeal, which was also denied. Discovery is presently progressing in the litigation in preparation for a trial on the merits.

SEC v. Sharon Steel Corp., et al.— The Commission, on September 21, 1977, filed a civil injunctive action in the United States District Court for the District of Columbia, and obtained a permanent injunction, by consent, against Sharon Steel Corporation (Sharon), Victor Posner (Posner), NVF Company (NVF), Steven Posner (S. Posner), Gail Posner Cohen (Cohen), Walter Gregg (Gregg), Bernard Krakower (Krakower), and DWG Corporation (DWG) as to certain violations of the antifraud, reporting, and proxy solicitation provisions of the Federal securities laws.[250] The Commission also obtained an Order mandating certain ancillary relief. The court also permanently enjoined Fingol Bloom (Bloom) from violations of the reporting and antifraud provisions of the Federal securi-

ties laws. In addition, Pennsylvania Engineering Corp. (PECOR) was permanently enjoined from violations of the proxy solicitation provisions of the Federal securities laws. Two other public companies, Southeastern Public Service Co. (SEPSCO) and Wilson Brothers (Wilson), subsidiaries of DWG, while not named as defendants, consented to a court Order to comply with the ancillary relief ordered as to the defendant corporations. All defendants were officers or directors of companies controlled by Posner.

The complaint alleged that, from 1970 to the present, Posner, S. Posner and Cohen, collectively the Posners, caused several public companies controlled by Posner (Sharon, NVF, DWG, PECOR, SEPSCO, and Wilson) to pay for a wide variety of non-business personal expenses for the Posners, costing such companies over $1,700, 000. The complaint also alleged that Sharon and its parent, NVF, filed false financial statements in 1974 and 1975.

The court ordered Posner, and his children, S. Posner and Cohen, to pay $600,000 to the various public corporations in repayment for certain of their personal expenses. The Judgment recited that the court proceedings should not be deemed to prevent any of the public companies which paid for the personal expenses of the Posners from making any claim against them.

The complaint alleged that the non-business personal expenses paid for on behalf of the Posners by the Posner-controlled companies included expenses for travel in a corporate jet, groceries, liquor, a vacation, entertainment, rent for certain of Posner's personal living quarters, restaurant expenses, use of a corporate yacht, medical bills, limousines and drivers, and domestic servants.

The complaint also alleged that Posner had caused the above-mentioned companies, which rent space in a Miami Beach hotel he controls, to expend over $100,000 in rentals over that charged to nonaffiliated residents. The complaint further alleged that Posner caused SEPSCO, DWG and other Posner-controlled public companies to expend over $1 million to refurbish the top two floors of the hotel, over $300,000 of which was used to refurbish a personal residential apartment for Posner.

The complaint further alleged that the companies controlled by Posner paid for the Posners' personal expenses described in the complaint without making any independent examination to determine if such charges were proper or legitimate corporate expenses. The complaint further alleged that from at least 1973 to the present, DWG, which directly paid for the majority of such personal expenses of the Posners, did not maintain any records which reflected the business purpose of the bulk of such expenditures.

The complaint further alleged that the annual reports, proxy statements and registration statements of the companies controlled by Posner failed to disclose, in violation of the antifraud provisions of the Federal securities laws, the nature and extent of such expenditures made on behalf of the Posners. The Complaint further alleged that Sharon, NVF, NVF's treasurer, Bloom, NVF's Vice Chairman, Gregg, and NVF's chief operating officer, McCracken, violated the antifraud provisions of the Federal securities laws when Sharon improperly valued and misrecorded major inventory items, misrecorded certain transactions as sales, shifted income and expenses from one year to another, and improperly transferred steel products among inventory accounts, which

falsified their financial statements for 1974 and 1975. The financial statements of Sharon and NVF for 1974 and 1975 were restated in 1977 with respect to these matters.

The complaint further alleged that in 1975, Sharon, which reported $25, 600,000 in pre-tax earnings overstated these earnings by approximately $13, 900,000. The complaint further alleged that Sharon increased its reported 1975 pre-tax earnings by $4, 929,000 by improperly revalueing virtually its entire inventory of iron ore through the treatment of a certain type of iron ore pellet called TPV as a "new item" in inventory, when such treatment was inconsistent with Sharon's past practice and, under generally accepted accounting principles, did not qualify for treatment as a new item.

The court enjoined Sharon, NVF, Posner, S. Posner, Cohen, DWG, and PECOR from using or causing the use of any asset of any public company related to the Posners for the personal benefit of the Posners unless such use has been properly authorized by such company's board of directors.

In addition, Sharon, NVF, DWG, and PECOR were ordered by the court and, as part of the settlement of the action, SEPSCO and Wilson have also agreed, to appoint two new independent directors satisfactory to the Commission, and to each set up a three member Audit Committee with the two new independent directors comprising two of the three members. Such Audit Committees are directed, among other things, to adopt financial controls designed to prevent occurrence of matters alleged in the complaint, to supervise implementation of such controls, to examine the matters alleged in the Commission's complaint, to recommend appropriate action, and to file such recommendations with the Commission. The companies were further directed to act on all such recommendations and file a report with an explanantion of the action taken and the reasons any such recommendation was not adopted. Such companies were also ordered to submit their proxy statements and their annual reports to independent counsel familiar with the Federal securities laws for review. As part of the settlement, Krakower stipulated that he will not practice before the Commission for any company other than a company related to Posner for one year. During such time the Commission has agreed not to bring proceedings against him pursuant to Rule 2(e) of the Commission's Rules of Practice based solely on the matters in the complaint, or the entry of the Final Judgment.

The court also enjoined Sharon, NVF, DWG, PECOR, Posner, S. Posner, Cohen and their agents from making false entries on the books of public companies controlled by Posners.

SEC v. Louis J. Roussel, Jr., et al.—On August 19, 1976, the Commission filed a complaint in the United States District Court for the Eastern District of Louisiana against Louis J. Roussel, Jr. (Roussel), National American Life Insurance Company (NALICO), ICB Corporation (ICB), American Benefit Life Insurance Company (American Benefit) and certain other entities and individuals.[251]

The Commission's complaint alleged that during the first half of 1975, Roussel conducted a successful takeover of Farm & Ranch Financial, Inc. (F&R), a Kansas insurance holding company. It was further alleged that the takeover was accomplished through a series of purchases by Roussel and persons and entities controlled, affiliated or associated with him, including certain of the defendants, in such a way as to circumvent the reporting and tender offer provisions of the

Federal securities laws and the Kansas Insurance Holding Company Act. The complaint indicated that private purchases of F&R stock were made during the effective period of NALICO's tender offer by Roussel, who arranged to have F&R stock, being accumulated on his behalf by principals and employees of certain defendants, placed with various persons and entities. The complaint alleged that no filing was made which revealed this purchasing activity or the shares accumulated in support of Roussel.

The complaint alleged violations of the Federal securities laws in connection with various transactions and events which took place at the ICB Corp., a one-bank holding company in New Orleans, during the period from 1970 through 1974. It was alleged that under the direction of certain of the defendants, loans were made to ICB employees, in connection with several unregistered ICB stock offerings to employees, which violated Federal bank credit regulations. Loans were also made to an employee pension plan which were also used to purchase ICB stock. The Commission charged that purchases of ICB stock in the open market by the employee stock purchase and pension plans had the effect, at various times, of dominating the market for ICB stock and that this domination was not publicly disclosed.

The complaint further alleged that ICB came under the control of Roussel in late October of 1974, and at that time employee stock purchase plans were terminated and the stock was purchased by Roussel at the request and with the aid of the then chairman and president of ICB. The Commission alleged employees lost portions of their investment as a result of their participation in an unregistered stock purchase plan which existed before Roussel's purchase. The Commission alleged that the employees were not informed of various material facts concerning the purchase plan, involving the right of registrants to recover their entire investment.

Certain of the defendants consented to the entry of Final Judgments of Permanent Injunction restraining and enjoining violations of certain provisions of the Federal securities laws without admitting or denying the allegations in the complaint.

As part of the extensive ancillary relief obtained in this case, Special Counsels were appointed to conduct investigations, independent directors were appointed to the board of directors of F&R and restitution was made to shareholders who tendered F&R securities in transactions which violated the tender offer provisions of the securities laws.

SEC v. Milgo Electronic Corporation, et al.—The Commission filed a complaint, in the United States District Court for the District of Columbia, seeking injunctive relief against Milgo Electronic Corporation (Milgo), a Florida corporation with its principal executive offices in Miami, Florida, and Racal Electronics Limited (Racal), a United Kingdom corporation with its principal executive offices in Bracknell, England.[252]

The Commission's complaint alleged that Milgo, in an effort to thwart an exchange offer for its common stock, made untrue statements of material facts and omitted to state material facts concerning, among other things, the purposes of a proposed sale of Milgo stock to Racal, the terms of Milgo's agreement with Racal and certain other facts.

The complaint further alleged that Racal had actual knowledge of a false and misleading press release of Milgo and participated in the events surrounding its issuance.

The Commission's complaint further alleged that Milgo violated the tender offer filing requirements of the Federal securities laws in failing to file with the Commission, Milgo management's statements concerning the exchange offer and Milgo's proposed sale of stock to Racal.

On February 3, 1977, the court entered a Judgment of Permanent Injunction against Milgo, enjoining Milgo from violations of certain of the tender offer, antifraud and reporting provisions of the Exchange Act and ordering certain other relief. Milgo consented to the entry of the Judgment without admitting or denying the allegations of the complaint.

In addition to the entry of the Judgment, the court ordered certain ancillary relief, including the following:

(1) An Undertaking by Milgo to amend its Schedules 14D filed with the Commission to reflect the institution of the Commission's action, the substance of the allegations in the complaint and the relief entered by the court;

(2) An Undertaking by Milgo to file Schedules 13D with the Commission with respect to any acquisition by Milgo of five percent or more of any equity security registered with the Commission pursuant to Section 12 of the Exchange Act; and

(3) An Undertaking to file with the Commission Schedules 14D with respect to any solicitation or recommendation by Milgo to Milgo shareholders to accept or reject a tender offer or request or invitation for tenders.

On May 13, 1977,[253] the court entered a Judgment of Permanent Injunction against Racal enjoining Racal from:

(1) Failing to timely file reports on Schedules 13D and 14D;

(2) Acquiring additional Milgo shares without prior approval of Milgo's shareholders and without disclosing all material facts;

(3) Making any solicitation or recommendation to Milgo's shareholders without complying with the Federal securities laws;

(4) Participating with an issuer whose stock is subject to a takeover bid in issuing any press release that is not in compliance with the Federal securities laws; and

(5) Purchasing or agreeing to purchase stock from any takeover target in violation of the tender offer and antifraud provisions of the Federal securities laws.

SEC v. Ormand Industries Inc., et al. —The Commission filed a complaint in the United States District Court for the District of Columbia against Ormand Industries, Inc. (Ormand), a corporation with principal offices in California which has engaged in outdoor advertising and other lines of business, and Jarrell D. Ormand (J.D. Ormand), formerly Chairman of the board of Ormand.[254]

The Commission's complaint alleged that J.D. Ormand and certain other officers, directors and employees of Ormand diverted substantial amounts of corporate funds and other corporate assets for their personal use. Among other things, the Commission's complaint charged that J.D. Ormand received cash advances which were unaccounted for in an amount exceeding $250,000 which were neither repaid by J.D. Ormand nor utilized for business purposes related to the company. Further, the Commission's complaint alleged that J.D. Ormand caused Ormand to provide personal benefits to J.D. Ormand. Such benefits, the Commission alleged, included payments for improvements on J.D. Ormand's residence, entertainment and other personal expenses for J.D. Ormand and members of his family.

The Commission's complaint alleged, in addition, that certain commercial transactions were not recorded on the books and records of Ormand and that false and misleading entries were made on the books and records of Ormand. With respect to the foregoing and other matters, the Commission alleged that Ormand filed false and misleading annual and periodic reports and proxy statements.

The court restrained and enjoined Ormand from further violations of the antifraud, reporting and proxy provisions of the Federal securities laws, and restrained and enjoined J.D. Ormand from further violations of the proxy provisions and ordered him to make complete and accurate filings with the Commission and statements to the public. In addition, the court ordered certain ancillary relief, including the following: the expansion of Ormand's board of directors to include three additional independent directors; the establishment and maintenance of an audit committee of the board of directors, composed of three members, including at least two of the newly-appointed directors; and the appointment of a special counsel to the audit committee to conduct an investigation and recommend corrective measures.

As additional ancillary relief, Ormand was ordered to undertake to implement and maintain internal control procedures designed to avoid the unauthorized or undisclosed use of corporate assets or other things of value for the benefit of officers, directors or employees of Ormand, its subsidiaries or affiliates.

The Delphi Capital Corporation Cases–Following a 2½ year investigation by members of the Commission staff and the Organized Crime Strike Force in Philadelphia, five related criminal cases were instituted in the Eastern District of Pennsylvania against 30 defendants. The cases were an outgrowth of the staff's earlier investigation that led to the revocation of the broker-dealer registration of Delphi Capital Corporation of Philadelphia in 1974. The following five cases were brought pursuant to this investigation.

U.S. v. Yiddy Bloom, et al.[255]—In this case, the grand jury returned a thirty-one count indictment against Yiddy Bloom of Miami Beach, Florida, a real estate investor and hotel owner; his son Jerrold Bloom of Coral Gables, Florida, a former securities salesman in Miami Beach, Florida; Jack Silbiger of Shawnee Mission, Kansas; Abraham Salaman of Philadelphia, Pennsylvania, former president of Delphi Capital Corporation; Ira Ingerman of Narberth, Pennsylvania, president of Magic Marker Corporation, and former chairman of the board of Delphi Capital Corporation; Burton Dubbin of Miami Beach, Florida, secretary-treasurer and a controlling person of Casa Bella Imports, Inc.; Albert London of Lincroft, New Jersey, former floor broker on the National Stock Exchange; Bernard Cronin of Magnolia, Massachusetts, former securities salesman in Washington, D.C.; Robert Street of Brooklyn, New York, former securities salesman in Washington, D.C.; Robert Knoth of North Palm Beach, Florida, former securities salesman in North Palm Beach, Florida; Michael Rekoon of Cranford, New Jersey, a former securities trader in New York City; Joseph Patrick of Glenside, Pennsylvania; a former trader and securities salesman in Philadelphia, Pennsylvania; Myron Freeman (also known as Mickey Freeman) of Annapolis, Maryland; and Joseph DeLoge of St. Petersburg, Florida, former securities trader in Montgomery, Alabama. The above-named defendants were charged with securities fraud, mail fraud and conspiracy to

violate the Federal securities laws and mail fraud schemes.

Named as unindicted co-conspirators were nine other persons including former National Stock Exchange personnel, former securities salesmen, former stock brokerage firm personnel, a former editor of an investment advisory publication, and a corporate president.

The indictment alleges that the defendants and co-conspirators conspired in 1971 and 1972 to manipulate the common stock of Magic Marker Corporation, a security then traded on the National Stock Exchange and over-the-counter.

The indictment also alleges a manipulation in 1972 by certain of the defendants of the common stock of Casa Bella Imports, Inc., a publicly owned company, the common stock of which was traded over-the-counter.

U.S. v. Charles Birkholz, et al.—In a related information filed by the United States Attorney, the Magic Marker specialist on the National Stock Exchange and 6 other persons, all of whom had been named as unindicted co-conspirators in the *Yiddy Bloom* case, above, were charged with various violations in connection with the manipulation of Magic Marker Corporation common stock, including conspiracy to violate the securities and mail fraud statutes, securities fraud, unlawful extension of credit, and Federal income tax violations.

Others named in the information were Harvey Klebanoff (also known as Harvey Kaye), a former executive vice president of Delphi Capital Corporation; Charles Birkholz, a Kansas florist; Stanley Levin, a floor broker on the National Stock Exchange; John Tees, a margin clerk at Delphi Capital Corporation; and Lawrence Richter and Jay Teitelbaum, both registered representatives.

U.S. v. Harvey Birdman, et al.[256]—In the third case, the grand jury returned a twenty-five count indictment against Harvey Birdman of Elkins Park, Pennsylvania, President of Uni-Shield International Corporation; Bernard Cronin of Magnolia, Massachusetts, a former securities salesman in Washington, D.C.; Alan Hunter of Wyndmoor, Pennsylvania, a former securities salesman in Philadelphia; William Richman of Philadelphia, Pennsylvania, a former financial consultant; Arthur Salaman of Wyncote, Pennsylvania; and Robert Street of Brooklyn, New York, a former securities salesman in Arlington, Virginia.

The indictment charged all of the above named defendants with conspiracy to violate Federal securities and mail fraud statutes. Birdman, Cronin, Hunter, Salaman and Street were also charged with violating and aiding and abetting the violation of antifraud provisions of the Federal securities laws and mail fraud statutes. Birdman was also charged with violating the ownership reporting requirements of the Federal securities laws. Also named as unindicted co-conspirators were two former securities salesmen. In the indictment it was alleged that Birdman and the other defendants and co-conspirators conspired in 1972 and 1973 to manipulate the price of the common stock of Uni-Shield International Corporation. At the time, the corporation had registered securities with the Commission and its common stock was listed on the National Stock Exchange.

U.S. v. Richard Kirschbaum, et al.[257]—In the fourth case stemming from the joint investigation, the grand jury returned a three count indictment charging Richard Kirschbaum of Oyster Bay, New York, and Stanley H. Molosky of Cherry Hill, New Jersey, a former securities salesman at Delphi Capital Corporation, with violations of

the securities fraud, mail fraud, and conspiracy statutes.

The indictment alleges that in 1972, Kirschbaum and unindicted co-conspirators, Joel Kline and Eric Baer, arranged for the purchase of U.S. Vinyl Corporation common stock from Max Zerkin and Associates, Inc., in return for a cash payment to them for each Vinyl share bought and that Molosky, pursuant to this scheme, purchased approximately 8,500 shares of U.S. Vinyl stock for his customers from Max Zerkin and Associates, Inc. Molosky and Kirschbaum are alleged to have shared in the resultant cash payments made by Kline.

The indictment also alleges that Molosky did not disclose the receipt of these cash payments to his customers.

U.S. v. Alan Hunter[258]—The final case resulted in a two count indictment charging Alan Hunter of Wyndmoor, Pennsylvania, with Federal income tax violations relating to his former employment as a securities salesman at Delphi Capital Corporation.

U.S. v. Theodore H. Kaufman, et al.—In April 1977 part of the Commission's referral of its investigative files to the Department of Justice in the Giant Stores Corporation matter, a fourteen count indictment was returned naming Theodore H. Kaufman, Jack S. Shapiro, Benjamin A. Lieberman and Gerald Silverstein, former officers of Giant, a bankrupt Massachusetts corporation.[259] The indictment alleged a conspiracy by the four defendants and other employees of Giant during 1971, 1972 and 1973 to issue false financial statements regarding Giant's income and balance sheets.

According to the main thrust of the indictment, the defendants sought to coverup a $2.5 million loss for the fiscal year ending January 29, 1972 by concealing liabilities and placing false assets on Giant's books.

The indictment also alleged that various falsified financials were included in filings with the Commission; one such filing was a registration statement in 1972 registering 300,000 shares of common stock which was sold to the public. In addition, the defendants transmitted the financial statements to various banks in Boston and thereby obtained loans totalling $13 million.

U.S. v. David Stirling, Jr., et al.— As part of the Commission's referral of its investigative files to the Department of Justice in the Stirling Homex Corp. matter, an eleven count indictment was returned on July 27, 1976 by the U.S. Attorney's Office in the Southern District of New York charging four of the former principal officers of Stirling Homex Corp., David Stirling, Jr., William G. Stirling, Harold M. Yanowitch and Edwin J. Schulz, and an attorney-employee for the company, Rubel L. Phillips, respectively with fraud in connection with the 1970 and 1971 public distribution and sale of nearly $40 million of Stirling Homex common and preferred stock.

The indictment charged that the defendants used several fraudulent devices to inflate Stirling Homex's earnings in SEC registration statements and annual and interim reports and related documents. The indictment charges that in 1969 and 1971, the defendants boosted reported sales and profits by including substantial sales of land to shell corporations which lacked any real ability to pay, and by making the sales at prices which were artificially inflated. The indictment also charges that, in 1971, a fraudulent sale of modules to a shell corporation was included in sales and profits on the basis of a forged

$15 million governmental financing commitment.

On January 29, 1977, a Federal jury convicted the five defendants. On March 11, 1977, a U.S. District Judge imposed a 1 year prison sentence and $10,000 fine on David Stirling Jr. Harold Yanowitch received a sentence of one year and a fine of $2,000. William Stirling received a sentence of six months and fine of $10,000. Rubel Phillips was sentenced to ten months in prison and a fine of $5,000. Finally, Edwin Schulz was fined $2,500 and given a suspended sentence.

Farmers' Cooperatives—In 1975 and 1976, various promoters throughout the South and Midwest offered and sold interests in a number of "cooperatives," organized under state farm cooperative laws. The promoters generally claimed that the "cooperatives" were exempt from registration under the Federal securities laws, pursuant to the private offering exemption. Generally, these cooperatives stress that they eliminate the need for consumers to deal with retail store "middlemen"; in their stead, the cooperatives offer physical locations at which farmers can collectively seek to sell their produce to the public. While no direct connection has been found yet, it appears that all the cooperatives have similar corporate structures and fund raising techniques, stressing the savings resulting from elimination of the "middleman". Nationwide, losses to investors have been estimated to be $3.8 million. The Chicago Regional Office on May 13, 1977, filed a civil injunctive action against Progressive Farmers Association, a Missouri based organization and the largest of the various cooperatives.[260] Additionally, a case involving the Producers and Consumers Cooperative Exchange has resulted in a criminal indictment against two defendants, one of whom has entered a plea of guilty.[261] This case appears to be the only criminal case brought to date with Federal assistance against promoters of these "cooperatives".

City of Philadelphia v. SEC—In May 1976, the Staff of the Philadelphia Branch Office commenced an informal inquiry into the sale of municipal securities issued by the City of Philadelphia. Upon receiving a request for information from the staff, the City not only refused to cooperate with the inquiry but also commenced an action against the Commission, seeking to enjoin the Commission, the individual Commissioners and members of the Commission's staff from any further conduct of the inquiry. The action also sought a declaration of the invalidity of the Federal securities laws insofar as they vest any jurisdiction in the Commission either to investigate the City of Philadelphia or to commence a civil action against that City should it be shown that the City engaged in fraud in the distribution of its securities. The Commission authorized the Office of the General Counsel to move to dismiss the action and the court granted the Commission's motion.[262]

Essentially, the court distinguished between an informal inquiry and a formal order of investigation, holding that, since no formal order has issued, the issues the City had raised in that regard were not ripe for review. Nevertheless, the court found that the City had standing to challenge the staff's preliminary inquiry and that, in that respect, the case was not moot.

The court's opinion rejected both of the City's challenges to the constitutionality of the Commission's informal inquiry. The City had argued, first, that limitations inherent in the Commerce Clause and the Tenth Amendment prohibit Congress from authoriz-

ing a Commission investigation of the City "because it impermissibly infringes upon the sovereignty of the Commonwealth of Pennsylvania, of which the City is a political subdivision." The City also argued a violation of the Fifth Amendment, asserting that the Federal securities laws provisions authorizing the Commission to investigate possible violations of the Federal securities laws by any "person" violate due process because they are impermissibly vague.

With respect to the Tenth Amendment challenge, the court adopted the Commission's interpretation of *National League of Cities v. Usery*,[263] by holding that Commerce Clause legislation may be invalidated under the Tenth Amendment if, and only if, that legislation "orders the states to act in 'areas of traditional governmental functions,' and, by virtue of this order, substitutes Federal for state choices in a manner which significantly limits the 'States' freedom to structure integral operations' in such areas". Although the court accepted as true, for purposes of the Commission's motion, that the Commission's preliminary investigation has a significant effect on the financing and distribution of municipal services, the court found that the "threshhold requirement that the Federal action *command* the City is lacking" since the City had not been compelled to do anything.

Moreover, the court expressly rejected the City's argument that the Commission's inquiry was impermissible, because it had a significant de facto effect upon states or their political subdivisions. The court noted that "such de facto effect is a necessary attribute of a Federal system."

In addition, the court, in a footnote reference, seemed to express passing approval of the Commission's argument that the *National League of Cities* case need not necessarily preclude congressional legislation that is found to intrude into the states' decision making in areas of traditional governmental functions, if it can be shown that the Federal interest is demonstrably greater and state compliance with imposed Federal standards would be essential. While the court reserved judgment on the constitutionality of a formal investigation, it did "recognize that the considerations relevant to the constitutionality of the 'preliminary' investigation may well be similar to those which are pertinent to the constitutionality of a 'formal' investigation".

With respect to the plaintiffs' argument that the statutes and regulations authorizing the "preliminary" investigation are void for vagueness, the court firmly sustained the sufficiency of the statutory provisions by noting that the securities laws and regulations "sufficiently specify the obligations imposed upon the City."

The City has appealed this decision to the United States Supreme Court.

City of New York v. SEC[264]—On July 26, 1976, the City of New York filed an action for declaratory and injunctive relief against the Commission and the Commissioners in their official capacity in the United States District Court for the Southern District of New York challenging the statutory basis and constitutionality of a pending formal Commission investigation into transactions in the City's securities. The complaint alleged that the investigation constituted unlawful "regulation" of the City and sought a declaratory judgment and an injunctive relief. Prosecution of the action was deferred by agreement and subsequently, in December, 1976, the suit was dismissed without prejudice by stipulation.

Bertoli v. Hills, et al.[265]—On April

5, 1976, Richard Bertoli, a respondent in an administrative proceeding initiated by the Commission, *In the Matter of Executive Securities, Inc., et. al.*[266], commenced an action for damages and injunctive relief in the United States District Court for the Southern District of New York, naming as defendants, Chairman Roderick M. Hills, Reynolds Securities, Inc., and Henry Gottlieb and alleging, among other things, extortion, subordination of perjury, cover-up and an invasion of plaintiff's personal privacy by members of the Commission's staff. On May 17, 1976, the court dismissed this action as to defendants Reynolds and Gottlieb. On July 30, 1976, the Commission and Chairman Hills filed a motion to dismiss, or in the alternative, for summary judgment. In support of its motion, the Commission argued that Chairman Hills was immune from private damage liability for the discretionary acts performed by him and Federal employees under his control in the exercise of their official responsibilities, and that the Commission, as an agency of the United States government, cannot be sued in its own name in the absence of its consent, which it did not give in this case.

The Honorable Charles L. Brieant dismissed the action as to the Commission and Chairman Hills, holding the Commission "immune from this sort of litigation, calculated to and having the effect of chilling it in the fearless exercise of its delegated quasi-judicial functions" and holding that, as to Chairman Hills, "to function effectively, he must be granted immunity from private suits for damages."

Sidney Buchman and Joseph Buchman v. *SEC*[267] — On April 20, 1977, the United States Court of Appeals for the Second Circuit, on a petition for review of a Commission order modifying disciplinary action taken by the NASD against principals of a broker-dealer, vacated the Commission's order. The brokerage firm had entered into a contract to purchase securities from another firm. Before the settlement date, the Commission suspended trading in the stock and continued to issue consecutive ten-day orders suspending trading in the stock for seven months. After the suspension terminated, the brokerage firm refused to accept delivery of the stock. The NASD, and the Commission, determined that the breach of contract constituted conduct inconsistent with "just and equitable principles of trade" in contravention of Article III, Section 1 of the NASD Rules of Fair Practice. The court, however, determined that there was no violation because the refusal to complete the contract was "colorably justified by the confusion as to the true state of the market and as to the applicable law." The court held that "[a] breach of contract is unethical conduct in violation of NASD rules, only if it is in bad faith, just as conduct violates Rule 10b–5 only if there is *scienter*: intent to deceive, manipulate or defraud."

Carter v. DeGrazia, et al. — In this case, the plaintiff alleged, *inter alia*, that a member of the Commission's staff had participated, together with a former employee of a Carter-affiliated company, and a law firm that had previously represented Mr. Carter, in a conspiracy to violate Mr. Carter's civil and constitutional rights in connection with the Commission-authorized investigation of Mr. Carter and certain companies that were affiliated with him.[268] In that connection, the complaint alleged (1) that there was no basis in fact for the Commissions' investigation; and (2) that its purpose was to force him out of business and to permit the former employee to take over that

business. He sought $25 million in damages.

After denying motions to dismiss, or in the alternative, for summary judgment, that were filed on behalf of the Commission staff member, the district court, on April 11, 1977, commenced the trial, which lasted three days. At that juncture, Mr. Carter admitted, during a bench conference, *inter alia*, that he had no specific evidence that the defendants conspired to put him out of business and that he had "no way of proving that allegation." The court thereupon vacated its prior orders denying the defendants' motions to dismiss and dismissed the complaint.

Mr. Carter subsequently sought review of the dismissal of the complaint in the court of appeals, but his appeal was dismissed as frivolous on September 20, 1977.[269]

SEC v. Advance Growth Capital Corporation et. al.[270] — In this case the United States Court of Appeals for the Seventh Circuit affirmed a district court's refusal to vacate a permanent injunction that had been entered in a Commission enforcement action.

Appellants, the two individual defendants in the action, had been permanently enjoined, on April 9, 1973, from engaging in certain conduct which would constitute violations of the Investment Company Act. On a writ of mandamus, the court of appeals had directed the district judge to enter a permanent injunction that had been drafted by the Commission's staff.

Twenty-seven months later, the appellants moved to vacate the injunction under Rule 60(b)(5) of the Federal Rules of Civil Procedure, which authorizes a district court to grant relief from a final judgment, *inter alia*, when "it is no longer equitable that the judgment should have prospective application . . . ." In support of their motion, they asserted, *inter alia*, that they had (a) complied with provisions of the Investment Company Act; (b) suffered embarrassment as a result of being enjoined; and (c) been denied the right to participate in the management of Advance Growth Capital Corporation. The district court denied the motion, on the ground that it lacked jurisdiction to modify or vacate the injunction without direction from the court of appeals.

Although the court of appeals found considerable authority to the effect that a motion in the same case for relief from a judgment entered pursuant to appellate mandate cannot be entertained by the trial court without appellate leave, it indicated that it would probably not go so far as to hold that appellate leave is necessary whenever relief is sought under Rule 60(b)(5).

The court of appeals affirmed the motion to vacate on the merits on the ground that any relief granted on the basis of the facts alleged in the motion would have been error, since the defendants had made no showing that they were suffering a grievous wrong as the result of new circumstances that were not forseen at the time the injunction was entered.

Sloan v. SEC[271] — In this case Samuel H. Sloan sought review of a Commission order,[272] dated April 28, 1975, that had revoked the broker-dealer registration of Samuel H. Sloan & Co. and barred him from association with any broker or dealer. The Commission's order was based upon findings that Mr. Sloan had willfully violated: (a) the recordkeeping provisions contained in Section 17(a) of the Exchange Act and Rule 17a–3 promulgated thereunder[273]; (b) the net capital requirements contained in Section 15(c)(3) of the Act and Rule 15c3–1 thereunder[274]; and (c) the requirements that broker-dealers report their

financial condition for the past calendar year,[275] their income and expenses for the past calendar year,[276] and any net capital deficiency within 24 hours after it occurs.[277]

The court of appeals affirmed the Commission's order, noting that, in addition to the Commission's findings of violative conduct, Mr. Sloan had been enjoined by the United States District Court for the Southern District of New York on two occasions from violating various provisions of the Federal securities laws.[278] The court held that "Each of these injunctions was in itself a sufficient ground to support the revocation of Sloan's broker-dealer license under §15(b)(5)(c) of the 1934 Act" and that his challenges with respect to the constitutionality of the Exchange Act were frivolous.[279]

Mr. Sloan subsequently filed a petition for a writ of certiorari in the Supreme Court, seeking review of the court of appeals' decision. His petition was denied on October 3, 1977.[280]

Whiteside & Co. v. SEC[281] — In this case the court of appeals upheld a Commission order affirming sanctions imposed by the NASD upon Whiteside and Company, a broker-dealer registered with the Commission and its two partners Clarence K. Whiteside and William H. Whiteside. This case involved Rule 15c3–3, 17 CFR 240.15c3-3, under Section 15(b) of the Exchange Act, 15 U.S.C. 78o(c). This Rule requires every broker or dealer to establish a "Special Reserve Bank Account for the Exclusive Benefit of Customers." The purpose of this account is to ensure that each broker or dealer retains adequate funds to cover its indebtedness to its customers. Under the rule, smaller brokers or dealers, such as the Whitesides, must make monthly computations pursuant to a specified formula and maintain a balance in the account of at least 105 percent of the net credit balance as calculated pursuant to the formulas. Any required deposit must be made no later than one hour after the opening of banking business on the second business day following the last business day of the month. If a required deposit is not made, the rule requires that immediate telegraphic notice be given to the Commission, SIPC, and the regulatory authority which examines the broker or dealer as to financial responsibility.

The court of appeals found that substantial evidence supported the Commission's finding that the Whitesides had failed to make necessary deposits and to give the required notice.

With respect to the sanction imposed, the court stated that "in light of the fundamental nature of the reserve account system to the safeguarding of customers funds," it could not find the Commission's affirmance of the NASD's sanctions to be arbitrary or an abuse of its discretion.

E. I. du Pont de Nemours & Co. v. Collins; SEC v. Collins.[282] — On June 23, 1976, the Court of Appeals for the Eighth Circuit, in a 2–1 decision, set aside an order of the Commission entered pursuant to Section 17(b) of the Investment Company Act granting a joint application by E. I. du Pont de Nemours & Co. and Christiana Securities Company which would permit the proposed merger of the two companies. The court of appeals held that the Commission had erred, as a matter of law, in determining that Christiana stock should be valued on the basis of the market value of its principal asset—du Pont common stock—rather than on a basis reflecting the much lower market value of the Christiana outstanding stock. It also held that because the benefits to Christiana

were far greater than to du Pont, the terms of the proposed merger were unfair—that they were not within the range of an arm's length bargain as, it held, is required under the Act.[283]

The Supreme Court reversed the judgment of the court of appeals and held that the Commission reasonably exercised the broad discretion granted to it by Congress, which, recognizing that an arm's length bargain is seldom a realistic possibility in transactions between an affiliate and an investment company, had substituted the Commission's informed judgment to determine the fairness of such transactions. The Court found that the Commission properly relied on the principle it has long and consistently applied—that the key factor in valuing the assets of a closed end investment company should be the market price of its portfolio securities.

Staff Report on Transactions in Securities of the City of New York

On August 26, 1977, the Commission transmitted to Congress its Staff Report on Transactions in Securities of the City of New York (the Report). The Report was the product of a 19-month investigation and focuses on events which occurred during the period from October 1974 through April 1975, when the City faced a fiscal crisis and issued very large amounts of short-term securities.

The Report was transmitted to Congress in response to requests from Senator William Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs; Congressman William S. Moorehead, Chairman of the House Banking Subcommittee on Economic Stabilization; and Congressman Benjamin Rosenthal, Chairman of the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs.

The Report was based on an investigation conducted by the Commission's New York Regional Office. That investigation was one of the most complex in the Commission's history and involved collection of more than 250,000 documents and over 12,000 pages of sworn testimony. It sought to: (1) determine the nature and extent of the knowledge of New York City officials, underwriters, rating agencies and bond counsel with respect to the then steadily-worsening financial condition of the City; and (2) compare the knowledge of these parties to the disclosures made to the public from October 1974 through April 1975—a period during which approximately $4 billion worth of New York City short-term debt securities were sold to the public.

The Report consists of seven chapters which examine the chronology of events related to the City's financial condition, the City's accounting practices and financial reporting, the role of the City and its officials and the role played, in connection with the offering and issuance of these securities, by the underwriters, bond counsel and the rating agencies.

The inquiry concluded that officials of New York City, with knowledge of the City's true financial condition, misled public investors in the offer and sale of its securities. The Report further found that the underwriters failed to fulfill their responsibilities to the investing public and inadequately disclosed materially adverse information regarding the budgetary and financial problems of the City.

According to the Report, the rating agencies appear to have failed, in a number of respects, to make either diligent inquiry into data which called for further investigation, or to adjust properly their ratings of the City's

securities based on data which they knew in a manner consistent with standards upon which prior rating had been based. As to bond counsel, who issued opinions on the validity of the issuance of New York City securities, the Report concluded that they, when on notice of circumstances which called into question matters basic to their opinions, should have conducted additional investigation. The Report also concluded that bond counsel, who continued with their engagement having knowledge of information material to investors, should have, under those circumstances, taken reasonable steps to satisfy themselves that such material facts were disclosed to the public.

As stated in the Report, the Federal securities laws administered by the Commission have as their principal purpose the protection of public investors. Accordingly, the staff inquired as to whether, in the offer, sale and distribution of New York City's debt securities, under the circumstances, there was provided the measure of disclosure mandated under the Federal securities laws in the interest of the investing public. The Report stated, "We conclude that it was not."

The Report is a distillation, analysis and evaluation of the evidence which had been obtained as of the date it was issued. The investigation, which is a continuing one, is not an adjudicatory proceeding; nor does the investigation or the Report constitute a determination of the rights or liabilities of any person.

The Commission will, after receiving staff recommendations, consider what Commission action or legislative recommendations, if any, should follow.

NOTES TO PART 1

[1]The Commission's report covers the periods from July 1, 1976 to September 30, 1976 (the transition quarter) and from October 1, 1976 to September 30, 1977 (fiscal year 1977). Unless otherwise indicated, references to the past fiscal year include the transition quarter.

[2]Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97.

[3]SEC, *Report of the Securities and Exchange Commission on Rules of National Securities Exchanges Which Limit or Condition the Ability of Members to Effect Transactions Otherwise Than on Such Exchanges* (September 2, 1975).

[4]Securities Exchange Act Release No. 11628 (September 2, 1975), 7 SEC Docket 762.

[5]*Id.* 7 SEC Docket 763.

[6]Securities Exchange Act Release No. 11942 (December 19, 1975), 8 SEC Docket 756.

[7]Although exchange members have been permitted to effect over-the-counter transactions in listed securities on an agency basis, Rule 19c–1 permitted each exchange to continue until January 2, 1977, to require its members to satisfy public limit orders on that exchange at prices equal to or superior to the over-the-counter transaction price as a condition to effecting any such transactions.

[8]Securities Exchange Act Release No. 11942 (December 19, 1975), 8 SEC Docket 766.

[9]*Id.*

[10]*Id.*

[11]*Id.* 8 SEC Docket 768–69.

[12]Letter to the Commission from the NMAB Concerning In-House Agency Cross Transactions in Listed Securities by Exchange Members, dated September 24, 1976.

[13]*Id.*

[14]*Id.* at 9.

[15]Letter to the Commission from the NMAB Concerning Off-Board Trading by Members of National Securities Exchanges, dated February 25, 1977.

[16]*Id.* at 2–3.

[17]Letter to the Commission from the NMAB Concerning Off-Board Trading by Members of National Securities Exchanges, dated May 19, 1977.

[18]*Id.*

[19]*Id.* at 3.

[20]*Id.*

[21]Securities Exchange Act Release No. 13662 (June 26, 1977), 12 SEC Docket 947.

[22]SEC, *Statement on the Future Structure of the Securities Markets* (February 2, 1972), 37 FR 5286 (1972).

[23]SEC, *Policy Statement on the Structure of a Central Market System* (March 29, 1973).

[24]Securities Exchange Act Release No. 9529 (March 8, 1972).

[25]Securities Exchange Act Release No. 10969 (August 14, 1974), 5 SEC Docket 735.

[26]Securities Exchange Act Release No. 11288 (March 11, 1975), 6 SEC Docket 425.

[27]Securities Exchange Act Release No. 11406 (May 7, 1975), 6 SEC Docket 859.

[28]Securities Exchange Act Release No. 12670 (July 29, 1976), 10 SEC Docket 108.

[29]Securities Exchange Act Release No. 13626 (June 14, 1977), 12 SEC Docket 835.

[30]Securities Exchange Act Release No. 12159 (March 2, 1976), 9 SEC Docket 76. *See also* December 1975 Release, 8 SEC Docket 773–76, and *infra* at p. 10 for a discussion of certain market linkage facilities proposed as alternatives to a composite book.

[31]Letter to the Commission from the NMAB concerning Establishment of a Composite Limit Order Book, dated January 28, 1977.

[32]*See* June 1977 Release for a discussion of market fragmentation. 12 SEC Docket 958–64.

[33]42nd Annual Report at 7–8; 41st Annual Report at 11; 40th Annual Report at 7; and 39th Annual Report at 9.

[34]Securities Exchange Act Release No. 12885 (October 12, 1976), 10 SEC Docket 697.

[35]*See* discussion, *supra* at p. 9.

[36]For a more detailed treatment of this request, *see* discussion, *infra* at p. 19.

[37]*See* Intermarket Execution System Discussion Paper, prepared by the National Market Association for the NMAB dated April 1977, and testimony of NYSE given during the August Hearings on August 2, 1977. (Official Transcript of Proceedings Before the Securities and Exchange Commission in the Matter of Off-Board Trading Rules, pp. 5–21) (both of which are available in File No. 4–180.)

[38]Letter to the Commission from Kenneth Rosenblum, Senior Vice President and Counsel of the MSE, dated September 9, 1977 (File No. 4–180).

[39]*See* discussion, *infra* at p. 19.

[40]Letter to the Commission from Michael Tobin, President of the MSE, dated March 22, 1977.

[41]Letter to the NMAB from Lee A. Pickard, Director, Division of Market Regulation, dated May 18, 1977.

[42]Letters to the MSE, the Amex, the NYSE and SIAC from the Commission, each dated October 4, 1977.

[43]NMAB, *Report to the Congress: The Possible Need for Modifications of the Scheme of Self-Regulation in the Securities Industry so as to Adapt it to a National Market System,* December 31, 1976.

[44]*See* discussion, *supra* at p. 5.

[45]Securities Exchange Act Release No. 13091 (December 21, 1976), 11 SEC Docket 1229.

[46]Securities Exchange Act Release No. 13092 (December 21, 1976), 11 SEC Docket 1248. Rule 10b–21 and the amendments to Rule 17a–3 were first proposed in Securities Exchange Act Release No. 10636 (February 11, 1974), 3 SEC Docket 540, and were reproposed in Securities Exchange Act Release No. 11328 (April 2, 1975), 6 SEC Docket 552.

[47]*See* 42nd Annual Report at 17–18; 41st Annual Report at 15–17; 40th Annual Report at 8–9; and 39th Annual Report at 10–11.

[48]*See* Securities Exchange Act Release No. 13230 (February 1, 1977), 11 SEC Docket 1630; and Securities Exchange Act Release No. 13674 (June 23, 1977), 12 SEC Docket 1014. After the end of the fiscal year, the Commission instituted proceedings to determine whether these proposals and those of other self-regulatory organizations designed either to expand existing programs for the trading of options or initiate new programs (the "Expansion Proposals") should be disapproved. *See* discussion of the Options Moratorium, *infra* at p. 14, and Securities Exchange Act Release No. 14057 (October 17, 1977), 13 SEC Docket 375.

[49]A standardized call option contract essentially gives the purchaser (its "holder") the right, until the contract expires, to purchase for a specified price (the "strike" or "exercise" price) a fixed number of shares of a given security (ordinarily 100 shares) (the "underlying security") from the seller (or "writer") of the call. Conversely, the purchaser of a standardized put option contract acquires the right to sell, before the option expires, a fixed number of shares of the underlying security (ordinarily 100 shares) to the writer of the put, at a specified price (the "strike" or "exercise" price) by the put option contract.

[50]*See* Securities Exchange Act Release No. 13592 (June 2, 1977), 12 SEC Docket 692; Securities Exchange Act Release No. 13587 (June 2, 1977), 12 SEC Docket 690; Securities Exchange Act Release No. 13588 (June 2, 1977), 12 SEC Docket 690; Securities Exchange Act Release No. 13591 (June 2, 1977), 12 SEC Docket 692; and Securities Exchange Act Release No. 13589 (June 2, 1977), 12 SEC Docket 691.

[51]As used here, the term "option class" means all option contracts of the same type, *i.e.*, put or call, covering the same underlying security.

[52]42nd Annual Report at 17.

[53]*Id.*

[54]*Id.*

[55]Securities Exchange Act Release No. 13045 (December 8, 1976), 11 SEC Docket 1120.

[56]*Id.*

[57]Securities Exchange Act Release No. 13051 (December 9, 1976), 11 SEC Docket 1124; Securities Exchange Act Release No.

13050 (December 9, 1976), 11 SEC Docket 1123; Securities Exchange Act Release No. 13080 (December 16, 1976), 11 SEC Docket 1220; and Securities Exchange Act Release No. 13058 (December 10, 1976), 11 SEC Docket 1173.

[58]By contrast, both the Amex and the Phlx, with some modifications, utilize unitary specialist systems in their options programs.

[59]The achievement of a centralized clearing system for listed options, the establishment of a common system for reporting and disseminating last sale information and the standardization of the terms of listed options, have facilitated such dual trading. Securities Exchange Act Release No. 10981 (August 22, 1974), 5 SEC Docket 224.

[60]At the end of the fiscal year, the Commission had pending before it a proposal by the PSE to permit dual trading with different expiration dates. Securities Exchange Act Release No. 12250 (March 23, 1976), 9 SEC Docket 259. Subsequent to the end of the fiscal year, the Commission instituted proceedings to determine whether this proposal and those of other self-regulatory organizations designed either to expand existing programs for the trading of options or to initiate new programs (the "Expansion Proposals") should be disapproved. *See* discussion of the Options Moratorium, *infra* at p. 14, and Securities Exchange Act Release No. 14057 (October 17, 1977), 13 SEC Docket 375.

[61]Such trading activity included "prearranged trading" and "wash sales" which involved option trades between exchange members which were entered into with the understanding that such trades were to be closed (reversed) within a short period of time at the same, or nearly the same, price. A related problem is "fictitious trading," which involves the reporting of transactions which do not actually occur.

[62]Securities Exchange Act Release No. 13433 (April 5, 1977), 11 SEC Docket 2194.

[63]*Id.*

[64]For a discussion of these inspections, see pp. 131-136, *infra*.

[65]These conferences were held at the Commission on March 7–8, 1977, March 31 to April 1, 1977, and on September 28–29, 1977.

[66]Securities Exchange Act Release No. 12334 (April 12, 1976), 9 SEC Docket 407; Securities Exchange Act Release No. 13160 (January 13, 1977), 11 SEC Docket 1447; Securities Exchange Act Release No. 13431 (April 5, 1977), 11 SEC Docket 2193; Securities Exchange Act Release No. 13071 (December 14, 1976), 11 SEC Docket 1179; and Securities Exchange Act Release No. 13161 (January 13, 1977), 11 SEC Docket 1448.

[67]Securities Exchange Act Release No. 13095 (December 22, 1976), 11 SEC Docket 1268; Securities Exchange Act Release No. 12703 (August 12, 1976), 10 SEC Docket 221; Securities Exchange Act Release No. 13406 (March 25, 1977), 11 SEC Docket 2150; Securities Exchange Act Release No. 12379 (April 27, 1976), 9 SEC Docket 493; and Securities Exchange Act Release No. 12539 (June 11, 1976), 9 SEC Docket 877.

[68]Securities Exchange Act Release No. 14056 (October 17, 1977), 13 SEC Docket 366.

[69]Securities Exchange Act Release No. 13760 (July 18, 1977), 12 SEC Docket 1275.

[70]*Id.*

[71]Securities Exchange Act Release No. 14056 (October 17, 1977), 13 SEC Docket 766.

[72]*Id.*

[73]Securities Exchange Act Release No. 14057 (October 17, 1977), 13 SEC Docket 375.

[74]*Id.*

[75]The impetus for the PSE's application for unlisted trading privileges was PRI's request that its securities be delisted from the PSE, where they had been listed since 1972. On June 22, 1977, the Commission ordered PRI stock removed from listing and registration on the PSE, effective upon the Commission's disposition of the PSE's application for unlisted trading, but in no event later than 120 days from June 22, 1977. Securities Exchange Act Release No. 13657 (June 22, 1977), 12 SEC Docket 930. In that order the Commission exempted, for the same time period, the NASD and all brokers and dealers from the requirements of Securities Exchange Act Rule 17a–15, which relates to last sale reports of OTC transactions in certain listed securities.

[76]Securities Exchange Act Release No. 13658 (June 22, 1977), 12 SEC Docket 933.

[77]Since June 22, 1977, PRI has been traded both on the PSE and in the OTC market. Such trading has been possible because the effective date of the delisting was deferred by the Commission pending resolution of PSE's application for unlisted trading privileges in that security and because the PSE had exempted from its off-board trading restrictions listed securities for which the issuer had applied for delisting and for which the PSE had applied for unlisted trading privileges. The latter action by the PSE enabled its members to act as dealers in PRI common stock in the OTC market if they desired.

[78]42nd Annual Report at 11.

[79]Securities Exchange Act Release No. 12055 (January 27, 1976), 8 SEC Docket 1155.

[80]Securities Exchange Act Release No. 13388 (March 18, 1977), 11 SEC Docket 2049.

[81]At the Joint Oversight Hearings conducted in July 1977 by the Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, the Commission was requested to furnish to the Subcommittee whatever legislative recommendations it wished to make. The Commission responded that it would not be in a position to make legislative recommendations until it had completed its rulemaking proceeding under Section 11(a). *See* letter to the Honorable John E. Moss and the Honorable Bob Eckhardt from Harold M. Williams, Chairman, Securities and Exchange Commission, dated August 19, 1977.

[82]Securities Exchange Act Release No. 12483 (May 26, 1976), 9 SEC Docket 731.

[83]The NASD is the only registered securities association.

[84]Securities Exchange Act Release No. 12994 (November 18, 1976), 10 SEC Docket 998.

[85]In this regard, Rule 19g2-1 defines "control" as the power to direct or cause the direction of the management or politics of a member company, and establishes certain rebuttable presumptions with respect to the control of a member.

[86]Securities Exchange Act Release No. 12395 (October 28, 1976), 10 SEC Docket 807.

[87]15 U.S.C. 78iii(c) (1970).

[88]42nd Annual Report at 22-23.

[89]*Id.* at 23. Securities Exchange Act Release No. 12802 (September 16, 1976), 10 SEC Docket 484. The term "NASDAQ" also refers to the automated quotation system developed by the NASD and now operated by its subsidiary, NASDAQ, Inc.

[90]Securities Exchange Act Release No. 13551 (May 19, 1977), 12 SEC Docket 434.

[91]Bradford's exemption was conditioned on requirements similar to those which the Commission previously imposed upon other processors exempted from registration. 42nd Annual Report at 23.

[92]*See* discussion *supra*, at p. 11.

[93]The provision of automated order routing systems by various exchanges was discussed in the 42nd Annual Report at 9-10.

[94]*See* note 41 *supra*.

[95]Securities Exchange Act Release No. 13726 (July 8, 1977), 12 SEC Docket 1107.

[96]Section 3(a)(23) of the Exchange Act defines the term "clearing agency" to include clearing corporations and depositories. Generally clearing corporations clear and settle transactions between participating brokers and dealers (*i.e.*, process trade data received from participating brokers and dealers and determine the amounts of securities and money that should be exchanged among them). Depositories hold securities certificates and effect delivery between participants by book entry.

[97]42nd Annual Report at 19.

[98]Securities Exchange Act Release No. 12795 (September 1, 1976), 10 SEC Docket 352.

[99]Securities Exchange Act Release No. 13584 (June 1, 1977), 12 SEC Docket 671. At the same time, the Commission issued an order extending until September 1, 1977, the existing registrations of The Depository Trust Company; Bradford Securities Processing Services, Inc.; Stock Clearing Corporation of Philadelphia; Boston Stock Exchange Clearing Corporation; Midwest Securities Trust Company; The Options Clearing Corporation; Midwest Clearing Corporation; Pacific Securities Depository Trust Company; Pacific Clearing Corporation; and TAD Depository Corporation. The Commission also announced the extension until September 1, 1977, of the time for concluding the registration proceedings. Three of the clearing agencies granted registration on December 1, 1975, had been combined to form the National Securities Clearing Corporation (NSCC) and their registrations were withdrawn in January 1977. See discussion, *infra* at p. 22.

Subsequently, the Commission extended until March 1, 1978, the interim registration of the above clearing agencies (other than NSCC whose interim registration had not expired) and extended until that date the time for concluding the proceedings. Securities Exchange Act Release No. 13911 (August 31, 1977), 12 SEC Docket 1640.

[100]Securities Exchange Act Release No. 12274 (March 29, 1976), 9 SEC Docket 305; Securities Exchange Act Release No. 12428 (May 11, 1976), 9 SEC Docket 622; and Securities Exchange Act Release No. 12825 (September 20, 1976), 10 SEC 527.

[101]Securities Exchange Act Release No. 12829 (September 24, 1976), 10 SEC Docket 593. Subsequently, proceedings were instituted with respect to NESDTC to determine whether to make permanent the interim registration granted to it. Securities Exchange Act Release No. 13664 (June 23, 1977), 12 SEC Docket 986.

[102]42nd Annual Report at 19.

[103]Securities Exchange Act Release No. 12954 (November 3, 1976), 10 SEC Docket 851.

[104]Securities Exchange Act Release No. 13163 (January 13, 1977), 11 SEC Docket 1448.

[105]*Bradford National Clearing Corporation v. Securities and Exchange Commission*, No. 77-1199 (C.A.D.C.).

[106]42nd Annual Report at 19.

[107]42nd Annual Report at 20.

[108]Securities Exchange Act Release No. 13293 (February 24, 1977), 11 SEC Docket 1818.

[109]Securities Exchange Act Release No. 13636 (June 16, 1977), 12 SEC Docket 853.

[110]That is, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. *See* Section 3(a)(34) of the Securities Exchange Act.

[111]Securities Exchange Act Release No. 13914 (September 8, 1977), 13 SEC Docket 17.

[112]Securities Exchange Act Release No. 12874 (October 7, 1976), 10 SEC Docket 693.

[113]The "open throat" area is space in the center of a certificate reserved for imprinting the record owner's name and address and other information.

[114]556 F.2d 555 (2d Cir. 1977).

[115]5 U.S.C. 552.

[116]*See* 42nd Annual Report at 20–21 for a description of the Commission's preliminary report on the Street Name Study and the initial steps taken by the Commission during the second phase of the Street Name Study.

[117]Securities Exchange Act Release No. 13719 (July 5, 1977), 12 SEC Docket 1111.

[118]Pub. L. No. 95–213 (December 19, 1977).

[119]*See infra* at p. 157, for a discussion of SIPC.

[120]In 1975, companion bills H.R.8064 and S.1231, 94th Cong., 1st Sess., were introducted in both houses of Congress. *See* 42nd Annual Report at 98–99.

[121][1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 95,627 (1976).

[122]NASD Manual (CCH) para. 2174 (April 21, 1977). Article III, Section 24, of the NASD's Rules of Fair Practice provides that selling concessions, discounts, or other allowances shall be allowed only as consideration for services rendered in a distribution and only to broker-dealers actually engaged in the securities business.

[123]Securities Exchange Act Release No. 13364 (March 9, 1977), 11 SEC Docket 1945.

[124]*Id.*, n. 9.

[125]Securities Exchange Act Release No. 13185 (January 19, 1977), 11 SEC Docket 1514.

[126]In a letter dated May 11, 1976, from Chairman Hills to NYSE Chairman Batten, the NYSE was urged to consider that suggestion.

[127]Securities Exchange Act Release No. 12806 (September 16, 1976), 10 SEC Docket 465.

[128]Securities Exchange Act Release No. 13508 (May 5, 1977), 12 SEC Docket 299.

[129]Securities Exchange Act Release No. 13661 (June 23, 1977), 12 SEC Docket 940.

[130]Section 17(f)(1) applies to every national securities exchange, member thereof, registered securities association, broker, dealer, municipal securities dealer, registered transfer agent, registered clearing agency and participant therein, member of Federal Reserve System and bank whose deposits are insured by the Federal Deposit Insurance Corporation. Although other financial institutions, such as insurance companies and foreign banks, are not included in the system, such institutions may write to the Commission to request to be included. Such applications will be considered on a case-by-case basis.

[131]Securities Exchange Act Release No. 13053 (December 28, 1976), 11 SEC Docket 1161.

[132]Securities Exchange Act Release No. 13280 (February 18, 1977), 11 SEC Docket 1804.

[133]Securities Exchange Act Release No. 13281 (February 18, 1977), 11 SEC Docket 1807.

[134]Securities Exchange Act Release No. 13831 (August 4, 1977), 12 SEC Docket 1465.

[135]Securities Exchange Act Release No. 13053 (December 28, 1976), 11 SEC Docket 1161.

[136]In Securities Exchange Act Release No. 13538 (May 24, 1977), 12 SEC Docket 339, AutEx, Inc., was named as the designee. SIC was created as a wholly owned subsidiary of the ITEL AutEx, Inc. after ITEL Corporation acquired AutEx, Inc.

[137]Reports and inquiries concerning United States Government or Agency securities are to be made to any Federal Reserve Bank or Branch.

[138]17 CFR 249.1200.

[139]The Lost and Stolen Securities Program is not intended to be a substitute for other steps being undertaken to improve securities processing, prevent losses and reduce the risk of theft. The Commission continues to endorse the immobilization and elimination of certificates through greater use of depositories and book entry systems.

[140]Securities Exchange Act Release No. 12214 (March 16, 1976), 9 SEC Docket 203. Securities Exchange Act Section 17(f)(2) provides that every partner, director, officer, and employee of every member of a national securities exchange, broker, dealer, registered transfer agent and registered clearing agency shall be fingerprinted and shall submit, or cause to be submitted, such fingerprints to the Attorney General of the United States for identification and appropriate processing. The Commission is given authority to exempt certain classes of persons from these requirements in a

manner consistent with the public interest and the protection of investors.

[141]For instance, in the case of a registered transfer agent, the rule requires the fingerprinting of only those persons engaged in or having access to "transfer agent activities."

[142]Securities Exchange Act Release No. 13105 (January 11, 1977), 11 SEC Docket 1311.

[143]The term "SECO broker-dealers" refers to those broker-dealers which are not members of the NASD.

[144]Securities Exchange Act Release No. 13679 (June 27, 1977), 12 SEC Docket 1017.

[145]Securities Exchange Act Release No. 12157 (March 2, 1976), 9 SEC Docket 45. The first set of notices under Section 31(b) generally concerned the issue of exchange membership and access to the exchanges. It is discussed in the 42nd Annual Report at 25.

[146]Securities Exchange Act Release No. 13027 (December 1, 1976), 11 SEC Docket 1066.

[147]Because both the Cincinnati and Spokane Stock Exchanges had indicated a desire to overhaul their respective sets of rules, the Commission found it preferable to send notices to these exchanges with respect to their entire rulebooks instead of citing specific rules.

[148]The Cincinnati Stock Exchange and Spokane Stock Exchange have responded pursuant to Section 19(b) of the Securities Exchange Act with proposed revisions of their rulebooks. *See* Securities and Exchange Commission File No. SR-CSE-77-1; and Securities and Exchange Commission File No. SR-SSE-77-1.

[149]Securities Exchange Act Release No. 14002 (September 27, 1977), 13 SEC Docket 238. Further notice was not given with respect to the other rules cited in the December 1, 1976, notice. The Commission expects that, before any further action on those rules is taken pursuant to Section 31(b), the rule will be the subject of an interim statement intended to facilitate additional consideration of the issues they present.

[150]Securities Exchange Act Release No. 13482 (April 28, 1977), 12 SEC Docket 239.

[151]Securities Exchange Act Release No. 13901 (August 29, 1977), 12 SEC Docket 1630.

[152]Securities Act Release No. 5758 (November 2, 1976), 10 SEC Docket 834.

[153]The original deadline for submission of comments of December 15, 1976 was extended to January 31, 1977 in Securities Act Release No. 5783 (December 15, 1976), 11 SEC Docket 1164.

[154]Securities Exchange Act Release No. 12999 (November 22, 1976), 10 SEC Docket 1006.

[155]Securities Act Release No. 5856 (August 18, 1977), 12 SEC Docket 1520.

[156]Securities Act Release No. 5758 (November 2, 1976), 10 SEC Docket 834.

[157]Securities Act Release No. 5808 (February 24, 1977), 11 SEC Docket 1779.

[158]*Id.*, 11 SEC Docket 1978-1803.

[159]Securities Act Release No. 5609 (August 25, 1975), 7 SEC Docket 696.

[160]Securities Act Release No. 5851 (August 10, 1977), 12 SEC Docket 1461.

[161]Securities Act Release No. 5859 (August 29, 1977), 12 SEC Docket 1598.

[162]Securities Act Release No. 5872 (September 29, 1977), 13 SEC Docket 227.

[163]Securities Exchange Act Release No. 13292 (February 24, 1977), 11 SEC Docket 1814.

[164]Securities Exchange Act Release No. 13787 (July 21, 1977), 12 SEC Docket 1256.

[165]Securities Exchange Act Release No. 12676 (August 2, 1976), 10 SEC Docket 143.

[166]Securities Act Release No. 5735 (August 31, 1976), 10 SEC Docket 313.

[167]Securities Act Release No. 5792 (December 20, 1976), 11 SEC Docket 1214.

[168]Securities Act Release No. 5879 (November 2, 1977), 13 SEC Docket 509.

[169]The form would still be available for the registration of securities to be offered by security holders and by the issuer upon the conversion of outstanding convertible securities and exercise of outstanding options.

[170]The use of the form will continue to be conditioned upon the issuer meeting the rules for the use of the Form S-7.

[171]Securities Act Release No. 5826 (May 10, 1977), 12 SEC Docket 340.

[172]See minutes of the Meetings of the Advisory Committee on February 8, 1977.

[173]Securities Act Release No. 5699 (April 23, 1976), 9 SEC Docket 472.

[174]Securities Act Release No. 5824 (April 28, 1977), 12 SEC Docket 78.

[175]45 U.S.C. 801 (February 5, 1976).

[176]Securities Act Release No. 5840 (July 1, 1977), 12 SEC Docket 1097.

[177]Securities Act Release No. 5827 (May 19, 1977), 12 SEC Docket 426.

[178]See Minutes of the Meeting of the Advisory Committee on Corporate Disclosure on October 22, 1976.

[179]The original deadline of August 1, 1977 for commenting on the concept release was extended to September 15, 1977 in Securities Act Release No. 5850 (August 9, 1977), 12 SEC Docket 1460.

[180]45 U.S.C. 801 (February 5, 1976).

[181]Securities Exchange Act Release No. 12769 (September 3, 1976), 10 SEC Docket 407.

[182]Securities Exchange Act Release

No. 13477 (April 28, 1977), 12 SEC Docket 228.

[183]Lessor railroads are substantially or wholly owned subsidiaries of operating railroads whose facilities or trackbeds are operated under lease pursuant to which the parent railroad is lessee. The income of the lessor subsidiary is determined pursuant to the lease arrangement based on the interest and a fixed dividend on the outstanding securities of the lessor. Switching and terminal companies are owned and operating railroads which share the expense of operation on a user basis.

[184]Securities Exchange Act Release No. 13478 (April 28, 1977), 12 SEC Docket 232.

[185]Securities Exchange Act Release No. 14032 (October 5, 1977), 13 SEC Docket 303.

[186]Under Section 12(h), the Commission, upon application and after notice and opportunity for hearing, may exempt in whole or in part any issuer from the provisions of Sections 12(g), 13, 14 or 15(d), if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and the extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.

[187]Investment Company Act Release No. 9470 (Ocotober 4, 1976), 10 SEC Docket 680.

[188]Investment Company Act Release No. 9482 (October 18, 1976), 10 SEC Docket 751.

[189]*Id.*

[190]Investment Advisers Act Release No. 602 (July 21, 1977), 12 SEC Docket 1337.

[191]No. 75–1870 (June 16, 1977).

[192]539 F.2d 649 (C.A. 7, 1976).

[193]547 F.2d 171 (C.A. 2, 1976).

[194]Litigation Release No. 7248, (January 23, 1976), 8 SEC Docket 1176.

[195]425 U.S. 185 (1976).

[196]544 F.2d 535 (C.A. 1, 1976).

[197]S.D.N.Y., No. 76 Civ. 2368. In Its complaint, the Commission alleged violations of registration, reporting and antifraud provisions of the Federal securities laws in connection with the sale of interests in oil and gas drilling programs to public investors.

[198]*SEC v. Petrofunds, Inc.*, 420 F. Supp. 958, 960 n. 9 (S.D.N.Y., 1976) (Weinfeld, Jr.).

[199]C.A. 2, No. 76-6184 (entered on April 12, 1977). Litigation Release No. 7908 (May 5, 1977), 12 SEC Docket 339.

[200]*SEC v. Petrofunds, Inc., supra*, 420 F. Supp. at 960.

[201]*Id.*

[202]*Id.* at 959.

[203]No. 76–1278 and No. 1536 (C.A.D.C., October 3, 1977), [Current Binder] CCH Fed. Sec. L. Rep. para 96,185.

[204]*Richard C. Spangler, Inc., Nassar and Co., Inc. and Albert Teller and Co., Inc.*, Securities Exchange Act Release No. 12104 (February 12, 1976), 8 SEC Docket 1257.

[205]CCH Fed. Sec. L. Rep., para. 96,185 at p. 92,341.

[206]Securities Exchange Act Release No. 12104 (February 12, 1976), 8 SEC Docket at 1268.

[207]CCH Fed. Sec. L. Rep., para 96,185 at p. 92,342.

[208]No. 75–2200 (C.A.D.C., 1977), [Current Binder] CCH Fed. Sec. L. Rep., para. 96,122.

[209]425 U.S. 185 (1976).

[210]546 F.2d 1361 (C.A. 10, 1976).

[211]557 F.2d 1008 (C.A. 3, 1977).

[212]Nos. 76-3543 and 76-3764, (C.A. 9, 1977).

[213]556 F.2d 619.

[214]The Commission order imposing these sanctions provided that, after one year, Mr. White could apply for leave to become associated with a broker-dealer in a nonproprietary capacity. Securities Exchange Act Release No. 12614 (July 9, 1976), 10 SEC Docket 7.

[215]430 F.Supp. 71 (C.D. Cal., 1977).

[216]558 F. 2d 1083 (C.A. 2, 1977).

[217]425 F. Supp. 212 (S.D.N.Y., 1977), *appeal pending*, C.A. 2, No. 77–6034.

[218]Oral argument of the case occurred shortly after the close of the fiscal year.

[219]No. 76-6189 (C.A. 2, September 30, 1977), [Current Binder] CCH Fed. Sec. L. Rep., para. 96,186.

[220]420 F. Supp. 1226 1244 (S.D.N.Y. 1976) (citations omitted).

[221]*Id.* at 1241.

[222]*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[223]CCH Fed. Sec. L. Rep., para. 96,186 at p. 92,350 (citations omitted).

[224]CCH Fed. Sec. L. Rep., para. 96,186 at p. 92,353 (citation omitted).

[225]432 F. Supp. 1190 (D.D.C., 1977), *appeal pending*, C.A.D.C., No. 1761.

[226]The Commission's existing rules already require disclosure of all *material* information. *See e.g.*, 17 CFR 230.408, 240.12b–20, and 240.14a–9.

[227]562 F. 2d 820 (C.A. D.C., 1977).

[228]With respect to the Big Horn activities, the Commission found that Collins Securities Corporation and Mr. Collins had wilfully violated Securities Act Section 17(a), 15 U.S.C. 77q(a), and Securities Exchange Act Section 10(b), 15 U.S.C. 78j(b), as well as Rules 10b–5 and 10b–6 thereunder, 17 CFR 240.10b–5 and 240.10b–6.

In addition, the Commission also found that Collins Securities Corporation and Mr. Collins had wilfully violated or willfully

aided and abetted violations of margin, reporting and recordkeeping requirements of the Federal securities laws.

[229]425 U.S. 185 (1976).

[230][1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep., para. 95,229 (S.D. N. Y., July 14, 1975).

[231]*Id.* at p. 98,207.

[232]No. 75–6111 (C.A. 2, 1976).

[233]425 U.S. 185 (1975).

[234]546 F. 2d 1044 (C.A. 2, 1976), certiorari denied sub nom., *Homans v. SEC* [Current] Fed. Sec. L. Rep. (CCH) 78,014.

[235]*Id.* at 1047.

[236]547 F. 2d 152 (C.A. 2, 1976), *petition for a writ of certiorari granted* Sup. Ct. No. 76-1607 (October 17, 1977).

[237]15 U.S.C. 78*o*(c)(5) and 15 U.S.C. 78s(a)(4).

[238]15 U.S.C. 78*l*(k).

[239]*Id.*

[240]Sup. Ct. No. 76–1607.

[241]Litigation Release Nos. 8077 and 8078 (August 22, 1977), 12 SEC Docket 1590.

[242]Litigation Release No. 7902 (May 2, 1977), 12 SEC Docket 336.

[243]Litigation Release No. 7902 (May 2, 1977), 12 SEC Docket 336.

[244]Securities Act Release No. 5800 (January 21, 1977), 11 SEC Docket 1548.

[245]Litigation Release No. 7651 (November 16, 1976), 10 SEC Docket 981.

[246]Litigation Release No. 7920 (May 12, 1977), 12 SEC Docket 421.

[247]Litigation Release No. 7581 (September 24, 1976), 10 SEC Docket 626.

[248]Litigation Release No. 7682 (December 3, 1977), 11 SEC Docket 1155.

[249]Litigation Release No. 7943 (May 27, 1977), 12 SEC Docket 743.

[250]Litigation Release No. 8119 (September 21, 1977), 13 SEC Docket 178.

[251]Litigation Release No. 7529 (August 19, 1976), 10 SEC Docket 263.

[252]Litigation Release No. 7921 (February 3, 1977), 11 SEC Docket 1110.

[253]Litigation Release No. 7921 (May 13, 1977), 12 SEC Docket 452.

[254]Litigation Release No. 7910 (May 9, 1977), 12 SEC Docket 415.

[255]Litigation Release No. 8103 (September 7, 1977), 13 SEC Docket 52.

[256]Litigation Release No. 8104 (September 7, 1977), 13 SEC Docket 52.

[257]Litigation Release No. 8082 (August 24, 1977), 12 SEC Docket 1593.

[258]Litigation Release No. 8105 (September 7, 1977), 13 SEC Docket 52.

[259]Litigation Release No. 7882 (April 20, 1977), 12 SEC Docket 72.

[260]Litigation Release No. 7932 (May 23, 1977), 12 SEC Docket 503.

[261]Litigation Release No. 7940 (May 25, 1977), 12 SEC Docket 506.

[262]City of Philadelphia v. SEC, 434 F. Supp. 281 (1977).

[263]426 U.S. 833 (1976).

[264]S.D.N.Y. No. 76–Civ. 3707.

[265]76 Civ. 1331 (CL 13).

[266]Admin. Proc. File No. 3–4694.

[267]553 F.2d 816 (C.A. 2, 1977).

[268]Civil Action No. 74–2263–S (D. Mass.) The Commission had entered orders for public proceedings, on the basis of the information acquired during the investigation: (1) to determine whether two Carter-affiliated companies had willfully violated the registration (Section 5 of the Securities Act, 15 U.S.C. 77e) and antifraud provisions of the Federal securities laws (Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b–5, 17 CFR 240.10b–5) promulgated under the latter Act) and whether Mr. Carter had willfully aided and abetted such violations (*In the Matter of Brokers Diversified Inc.*, Administrative Proceeding File No. 3–4421 (January 15, 1974)); and (2) to determine whether a proposed stock offering of another Carter-affiliated company would violate registration and antifraud provisions of the Federal securities laws (*In the Matter of Brokers Diversified Services Corp.*, Administrative Proceeding File No. 3–4436 (Feb. 12, 1974)). The Commission consolidated the proceedings and thereafter, on August 1, 1974, following the filing of Mr. Carter's complaint, entered a default order based on basis of his failure to appear at a scheduled administrative hearing. The Commission's order found that Mr. Carter had aided and abetted violations of registration and antifraud provisions of the Federal securities laws in connection with the offer and sale of common stock of two affiliated companies between June 1972 and January 1974.The order also barred Mr. Carter from being associated with any broker-dealer. *In the Matter of Brokers Diversified, Inc., et al.*, Securities Exchange Act Release No. 10938 (August 1, 1974).

[269]Docket No. 77-1228 (C.A. 1), *petition for a writ of certiorari denied*, Sup. Ct. No. 77–5501.

[270]539 F.2d 649 (C.A. 7, 1976).

[271]547 F.2d 152 (C.A. 2, 1976), *petition for a writ of certiorari denied* Sup. Ct. No. 76–1547 (October 3, 1977).

[272]Securities Exchange Act Release No. 11376 (April 28, 1975), 6 SEC Docket 772.

[273]15 U.S.C. 78q(a) and 17 CFR 240.17a-3 respectively.

[274]15 U.S.C. 78*o*(c)(3) and 17 CFR 240.15c3-1 respectively.

[275]Rule 17a-5, 17 CFR 240.17a-5.

[276]Rule 17a-10, 17 CFR 240.17a-10.

[277]Rule 17a-11, 17 CFR 240.17a-11.

[278]*Sloan v. SEC, supra*, 547 F.2d at 155.

[279]*Id.*

[280]Sup. Ct. No. 76–1547.

[281]557 F.2d 1118 (C.A. 5, 1977).

[282]97 S. Ct. 2229 (1977).

[283]The Commission's application for *en banc* rehearing was denied.

Part 2
The Disclosure System

Part 2 The Disclosure System

A basic purpose of the Federal securities laws is to provide disclosure of material, financial, and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This aims at enabling investors to evaluate the securities of these companies on an informed and realistic basis.

The Securities Act of 1933 generally requires that before securities may be offered to the public a registration statement must be filed with the Commission disclosing prescribed categories of information. Before the sale of securities can begin, the registration statement must become "effective." In the sales, investors must be furnished a prospectus containing the most significant information in the registration statement.

The Securities Exchange Act of 1934 deals in large part with securities already outstanding and requires the registration of securities listed on a national securities exchange, as well as over-the-counter securities in which there is a substantial public interest. Issuers of registered securities must file annual and other periodic reports designed to provide a public file of current material information. The Exchange Act also requires disclosure of material information to holders of registered securities in solicitations of proxies for the election of directors or approval of corporate action at a stockholder's meeting, or in attempts to acquire control of a company through a tender offer or other planned stock acquisition. It provides that insiders of companies whose equity securities are registered must report their holdings and transactions in all equity securities of their companies.

PUBLIC OFFERING: THE 1933 SECURITIES ACT

The basic concept underlying the Securities Act's registration requirements is full disclosure. The Commission has no authority to pass on the merits of the securities to be offered or on the fairness of the terms of distribution. If adequate and accurate disclosure is made, it cannot deny registration. The Act makes it unlawful to represent to investors that the Commission has approved or otherwise passed on the merits of registered securities.

Information Provided

While the Securites Act specifies the information to be included in registration statements, the Commission has the authority to prescribe appropriate forms and to vary the particular

items of information required to be disclosed. To facilitate the registration of securities by different types of issuers, the Commission has adopted special registration forms which vary in their disclosure requirements so as to provide maximum disclosure of the essential facts pertinent in a given type of offering while at the same time minimizing the burden and expense of compliance with the law. In recent years, it has adopted certain short forms, notably Forms S-7 and S-16, which do not require disclosure of matters already covered in reports and proxy material filed or distributed under provisions of the Securities Exchange Act. Another short form for registration under the Securities Act is Form S-8 for the registration of securities to be offered to employees of the issuer and its subsidiaries. Recent Commission actions to amend the three forms referred to above are discussed below.

Reviewing Process

Registration statements filed with the Commission are examined by its Division of Corporation Finance for compliance with the standards of adequate and accurate disclosure. Various degrees of review procedures are employed by the Division.[1] While most deficiencies are corrected through an informal letter of comment procedure, where the Commission finds that material representations in a registration statement are misleading, inaccurate, or incomplete, it may, after notice and opportunity for hearing, issue a "stop-order" suspending the effectiveness of the statement.

Time for Registration

The Commission's staff tries to complete examination of registration statements as quickly as possible. The Securities Act provides that a registration statement shall become effective on the 20th day after it is filed (or on the 20th day after the filing of any amendment). Most registration statements require one or more amendments and do not become effective until some time after the statutory 20-day period. The period between the filing and effective date is intended to give investors an opportunity to become familiar with the proposed offering through the dissemination of the preliminary form of prospectus. The Commission can accelerate the effective date to shorten the 20-day waiting period—taking into account, among other things, the adequacy of the information on the issuer already available to the public and the ease with which facts about the offering can be understood.

During the 3 months ended September 30, 1976, 637 registration statements became effective. Of these, 72 were amendments filed by investment companies pursuant to Section 24(e) of the Investment Company Act of 1940, which provides for the registration of additional securities through amendment to an effective registration statement rather than the filing of a new registration statement. For the remaining 565 statements, the median number of calendar days between the date of the original filing and the effective date was 28.

During the 1977 fiscal year, 2,921 registration statements became effective, including 402 which were amendments filed by investment companies. The median number of calendar days between the date of the original filing and the effective date for non-investment company filings was 16.

Recent Actions Concerning the Registration Process

The Commission continuously monitors its disclosure forms and the rules

concerning the procedures for registration statements and exemptions under the Securities Act to assure that the provisions are current and adequate, and to assure that they do not involve undue burdens on registrants. Actions of this general nature occurring during the period covered by this report are discussed under the following headings.

Form S-8

On November 22, 1976 the Commission adopted amendments to Form S–8[2] substantially as previously proposed[3] but with several significant modifications. In considering the over 160 letters of comment, the Commission, in addition to responding with significant changes to further simplify the disclosure requirements together with the wider availability of the new form, made major changes to: (1) delete the regulatory conditions governing the availability of the form; (2) modify the limitations on the use of the form for reoffers and resales; and (3) delete the requirement for an opinion of counsel concerning compliance with the Employee Retirement Income Security Act of 1974.

As proposed, Form S–8 would not have allowed reoffers to be made by affiliates or underwriters through the use of the Form S–8 prospectus. No person can use the new Form S–8 prospectus for reoffers or resales. The new form continues with the prohibition in the use of a Form S–8 prospectus for reoffers and resales by "affiliates" but goes on to allow any affiliates to make registered reoffers of certain amounts of securities acquired pursuant to a registration statement on Form S–8 through the use of a Form S–16 or S–1 prospectus as indicated under general Instruction E of the Form S–8. The Form S–16 or S–1 prospectus can be filed as part of the registration statement on Form S–8 and need not be the subject of a new, separate registration statement or any new filing fee. Persons deemed to be "underwriters" may utilize the reoffer and resale procedure specified for affiliates in general Instruction E or comply with the provisions of Rule 144. Persons not deemed to be "affiliates" or "underwriters" of the issuer make reoffers or resales under the exemption afforded by Section 4(1) of the Securities Act, presupposing that these persons satisfy the requirements for the exemption. These procedures are designed to provide adequate notice to the public and to the Commission with respect to the registered reoffer of securities.

The new form became effective for all registration statements and post-effective amendments filed on Form S–8 after December 31, 1976.

Amendments to Forms S–7 and S–16 and Rescission of Form S–9.

On December 20, 1976, the Commission adopted amendments to Forms S–7 and S–16 and rescinded Form S–9 under the Securities Act.[4] These amendments were adopted substantially as proposed[5] and generally expand the availability of the S–7 and S–16 short form registration statements to additional issuers which are subject to the reporting requirements of the Exchange Act.

Issuers using Forms S–7 and S–16 are permitted to omit from the Form S–7 prospectus, or to incorporate by reference in the Form S–16 prospectus, certain information already provided to security holders or available to investors in reports filed under the Exchange Act. Thus, the amendments reflect recent improvements in the nature and extent of information required to be included in reports and

proxy and information statements under that Act, and the increased availability of such information to the investing public.

Among the principal changes in the availability of the Forms S–7 and S–16 are their expansion to issuers with a class of debt securities listed on a national securities exchange or a class of securities subject to Section 15(d) of the Exchange Act; the elimination of the requirement that a majority of the registrant's board of directors must have served during the prior three years; the reduction in the net income test from the present requirement of $500,000 for each of the prior five years to $250,000 for three of the last four years, including the most recent year; the deletion of any requirement that the issuer must have had income adequate to cover dividends paid for the prior five years; and the reduction of the present ten year test to a new thirty-six month standard within which the registrant must not have had any defaults in the payment of any dividend or sinking fund installment on preferred stock, or installment on indebtedness. Also, Form S–7 was made available for the registration of securities in any type of offering, such as exchange offers, not solely in cash offerings as was previously required. At present, Form S–16 may be used only for certain types of offerings, most commonly those by persons other than the issuer.[6]

In addition, certain of the disclosure items of Form S–7 were amended to require additional information if the securities are to be offered in exchange for the assets or securities of any other person. Such information relates to the management of the issuer and to the person whose assets or securities are the subject of the offer. Also, if there has been a recent change in control of the issuer, Forms S–7 and S–16 were amended to require that certain additional disclosure concerning such change in control and the management of the issuer be made in the prospectus if not previously reported pursuant to the Securities Act or the Exchange Act.

Form S–9 previously was a short registration form for use by issuers in registering certain debt securities under the Securities Act if they met certain minimum earnings coverage ratios in their debt securities. Since the form had not been widely used recently and since the amended Form S–7 is now available to virtually all issuers which could previously have used Form S–9, the Commission rescinded Form S–9.

Registration Form for Business Combination Transactions

On September 27, 1976, the Commission published for comment proposed Form S–14A,[7] an optional short form for registration under the Securities Act of securities of certain issuers to be issued in reclassifications and business combination transactions of the character described in Securities Act Rule 145(a), and proposed amendments to related rules.[8] The proposed form provided for a short prospectus (which could be in the form of a proxy or information statement), consisting principally of information concerning the transaction in which the registered securities would be issued. More detailed information concerning the transaction and the parties to the transaction would be filed with the Commission as a new Part II of the registration statement and incorporated by reference in the prospectus. The registrant would be required to provide Part II at its own expense, upon request. These proposals were intended to result in cost savings

to registrants and to provide disclosure to investors in a simpler, more understandable form.

During the comment period, which expired January 10, 1977, 22 comments were received. Although the comments indicated overwhelming support for the Commission's goals of simplifying disclosure for investors and reducing the burdens on registrants, a large number of commentators felt that the differential disclosure approach embodied in the proposed form did not achieve these goals.

In February, 1977, the Commission announced that, in light of the comments received on proposed Form S-14A, it did not intend to adopt the form at that time.[9] Instead, the Commission invited comment on the advisability of developing a new registration form for the same purpose. The new form, as contemplated, would consist of a single, abbreviated prospectus (and proxy or information statement) which would incorporate by reference reports filed under the Exchange Act and/or the issuer's annual report to shareholders. The staff of the Division of Corporation Finance will consider both the comments received on this matter and the recommendations of the Advisory Committee on Corporate Disclosure.

Rule 146

The so-called "private offering" exemption from registration under the Securities Act, Section 4(2), provides that offers and sales by an issuer not involving any public offering will be exempt from registration. The section has long been a source of uncertainty for issuers wanting to sell their securities in private placements. In April 1974, the Commission adopted Rule 146 under the Securities Act, "Transactions by an Issuer Deemed Not to Involve Any Public Offering," which is designed to protect investors while at the same time providing more objective standards to curtail uncertainty as to the meaning of Section 4(2) to the extent feasible.[10]

In general, the rule provides that transactions by an issuer meeting all the conditions of the rule do not involve "any public offering." Major conditions to be met are essentially that (1) there must be no general advertising or solicitation in connection with the offering; (2) offers can be made only to persons the issuer reasonably believes have the requisite knowledge and experience in financial and business matters, or can bear the economic risk; (3) sales can be made only to persons the issuer reasonably believes have the requisite knowledge and experience, or who can bear the economic risk and have an advisor (meeting certain standards) who can provide the requisite knowledge and experience; (4) all offerees either must have access to or must be furnished with the type of information that registration would disclose; (5) there can be no more than 35 purchasers of securities in the offering; and (6) reasonable care must be taken to prevent resale of the securities in violation of the registration provisions of the Securities Act.

Rule 146 does not provide the exclusive means for offering and selling securities in reliance on Section 4(2). Issuers may continue to rely on the Section 4(2) exemption by complying with relevant administrative and judicial criteria at the time of a transaction. The staff of the Commission will issue interpretive letters to assist persons in complying with the rule, but will issue no-action letters relating to Section 4(2) only in the most compelling circumstances.

In December 1976, the Commission requested from the public empirical

information regarding the operation of Rule 146 and whether it should be revised, retained or rescinded.[11] Moreover, specific recommendations for amendments to the rule were sought. The request was prompted by criticism that the rule has hindered the investment of venture capital and has facilitated the fraudulent offering of certain types of securities. Subsequently, the Commission proposed an amendment to the rule which would require the filing of a notice when the rule is used.[12]

The majority of the comments favored retention of the rule; it is expected that several amendments to the rule will be proposed in order to increase its availability to issuers and improve its efficiency.

Proposed Rule 148 and Amendments to Form 8-K

On September 16, 1977 the Commission proposed the adoption of Rule 148 under the Securities Act, which would establish objective standards for the resale of certain types of securities relating to bankruptcy proceedings.[13] The purpose of the proposed rule is to provide some degree of certainty as to when a person could sell such securities without the need for registering them under the Act. In a related matter, the Commission also proposed the adoption of certain amendments to Form 8-K under the Exchange Act for the purpose of assuring that current information about a debtor and the bankruptcy proceedings in which it has participated will be available to the public shortly after such proceedings have been completed.

Status of Securities Acquired Pursuant to an ESOP

On October 8, 1976 the Commission announced that the Division of Corporation Finance issued a letter[14] reversing the position stated in Securities Act Release No. 5223, January 1, 1972 and Securities Act Release No. 5243, April 12, 1972, regarding the status of securities acquired pursuant to an Employee Stock Ownership Plan (ESOP). Under prior practice, the Commission took the position that securities acquired pursuant to stock bonus or similar plans were included within the Rule 144 definition of "restricted securities." Accordingly, the Division of Corporation Finance, in issuing interpretive and "no-action" letters, consistently took the position that common stock acquired by a trustee of an ESOP, from the issuer, for allocation, distribution and subsequent sale by employees of the issuer would be "restricted securities" for purposes of Rule 144.

The Commission reconsidered this position and, in light of the possible burdens of non-affiliate employee compliance with the provisions of Rule 144 compared with the limited benefits of compliance, if any, along with the facts set forth in the letter, concluded that it was not in the public interest or in the interest of the protection of investors to take the position that ESOP shares in the hands of non-affiliate employees are "restricted" where the plan does not function as a conduit for distribution to the public. As indicated in Release No. 5750, the volume of shares contributed to the plan vis-a-vis the company's outstanding shares as well as the length of time the plan holds the shares prior to distribution to participants are important factors in reaching a conclusion on this issue. Therefore, where (1) the corporation is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, (2) the corporation's common stock is actively traded on an exchange or in the over-the-counter

market, and (3) the number of shares issuable pursuant to the plan is small in relation to the number of shares presently issued and outstanding, the Commission has authorized the Division to take the view that shares issued and to be issued as bonuses do not constitute "restricted securities" within the meaning of Rule 144. Affiliates would be required to use Rule 144 for resales absent registration of their shares.

Undertaking to Provide Financial Information Added to Guide 60

On September 27, 1976 the Commission approved the addition of Section 21(c), "Undertaking to Provide Financial Information" to Guide 60, "Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships".[15] Section 21(c) requests that registrants undertake to furnish to investors the financial statements required by Form 10–K for one full year of operations after the effective date of a registration statement relating to a real estate limited partnership. The purpose of this undertaking is to try to assure that investors receive financial information for at least the first year of actual operations. In many instances, the issuers obligation to file reports under the Exchange Act terminates before the proceeds of the offering are fully invested so that the investor never receives financial information of the type required by Form 10–K relating to partnership operations.

Guide 42

On June 13, 1977[16] the Commission announced that it is considering clarification or amendment of Guide 42, "Reports or Memoranda Concerning the Registrant," one of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933. This guide requires that certain reports or memoranda be furnished to the staff as supplemental information in connection with submission of a registration statement in order that the staff have access to materials necessary and helpful for its review of registration statements and that the staff be able to discern whether any conditioning of the market has taken place prior to the proposed offering. The Commission's consideration of the guide is focusing on whether its requirements are unnecessarily broad and whether there is a consensus of understanding on the part of the securities industry and its counsel as to the guide's requirements, purposes and operation.

Delegation of Authority

The Commission delegated to the Director of the Division of Corporation Finance its authority to issue releases announcing that the Secretary of the Treasury, pursuant to authority contained in Section 3(a) (12) of the Exchange Act, has designated certain securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as "exempted securities" under the Act. This delegation of authority will result in more timely notice to the public of the designation of a new exempted security by eliminating any delay caused by seeking Commission approval for release of the information.[17]

Amendments to Rules 424 and 429

In order to expedite the processing of prospectuses and to reduce the filing burden on issuers, the Commission adopted certain minor amendments to Rules 424 and 429 under the Securities Act.[18] The amendments reduce the number of copies of prospectuses required to be filed and require that certain data be set forth on the front pages of such documents.

Rescission of Rule 458

The Commission rescinded Rule 458 on July 5, 1977.[19] This rule required corporations to submit with an initial filing of a registration statement a brief summary of that statement for the Commission's use. The summary, which was used to prepare notices of filing of registration statements included in the SEC News Digest, is no longer being required because the Commission believes that this will reduce paperwork and ease the burdens on corporations which are preparing registration statements and that the Commission staff can write a shorter version of News Digest notices themselves.

The notices in the Digest continue to give the following information: (1) the file number; (2) the form on which the registration statement is filed; (3) the name, address and phone number of the issuer of the security; (4) the title and the number or face amount of the securities being offered; (5) the name of the managing underwriters, if any; and (6) whether the offering is a rights offering. The editors of the Digest are now considering whether additional information should be set forth in the notices.

Office of Engineering

During the fiscal year the Division reorganized the functions previously performed by the Office of Oil and Gas and the Office of Engineering by consolidating all of the Division's engineers and geologists in one office, which was designated the Office of Engineering.

This office is responsible for reviewing from a technical standpoint the disclosure in all filings involving oil and gas, mining, aerospace, and other engineering and geological matters. Sixty-five registration statements were examined during fiscal 1977 for oil and gas drilling programs, totaling $808,851,466. In the transition quarter of July through September 1976, 11 oil and gas drilling programs totaling $117,505,000 were examined.

Additional information regarding certain offerings of fractional undivided interests in oil and gas rights is contained under Regulation B in this part.

SMALL ISSUE EXEMPTION

The Commission is authorized under Section 3(b) of the Securities Act to exempt securities from registration if it finds that registration for these securities is not necessary to the public interest because of the small offering amount or limited character of the public offering. The law imposes a maximum limitation of $500,000 upon the size of the issues which may be exempted by the Commission.

The Commission has adopted the following exemptive rules and regulations:

Regulation A:	General exemption for U.S. and Canadian issues up to $500,000.
Regulation B:	Exemption for fractional undivided interests in oil or gas rights up to $250,000.
Regulation E:	Exemption for securities of a small business investment company up to $500,000.
Regulation F:	Exemption for assessments on assessable stock and for assessable stock offered or sold to realize the amount of assessment up to $300,000.

Rules 234-237 and 240: Exemptions of first lien notes, securities of cooperative housing corporations, shares offered in connection with certain transactions, certain securities owned for five years and certain limited offers and sales of small dollar amounts of securities by closely-held issuers.

Regulation A

Regulation A permits a company to obtain needed capital not in excess of $500,000 (including underwriting commissions) in any one year from a public offering of its securities without registration, provided specified conditions are met. Among other things, a notification and offering circular supplying basic information about the company and the securities offered must be filed with the Commission and the offering circular must be used in the offering. In addition, Regulation A permits selling shareholders not in a control relationship with the issuer to offer in the aggregate up to $300,000 of securities which would not be included in computing the issuer's $500,000 ceiling.

During the transitional quarter, 54 notifications were filed under Regulation A, covering proposed offerings of $20,433,368. A total of 78 reports of sales were filed reporting aggregate sales of $7,699,859. Such reports must be filed every six months while an offering is in progress and upon its termination.

During the 1977 fiscal year, 218 notifications were filed under Regulation A, covering proposed offerings of $78,209,915 as compared with 240 notifications covering proposed offerings of $83,528,448 in the prior year. A total of 356 reports of sales were filed reporting aggregate sales of $37,920,060. As stated above such reports must be filed every six months while an offering is in progress and upon its termination. Sales reported during 1976 had totaled $41 million. Various features of Regulation A offerings over the past three years and the transitional quarter are presented in the Part 9 of the report.

In the transitional quarter the Commission temporarily suspended 2 exemptions where it had reason to believe there had been noncompliance with the conditions of the regulation or with disclosure standards, or where the exemption was not available for the securities. Added to 6 cases pending at the beginning of this quarter, this resulted in a total of 8 cases for disposition. Of these the temporary suspension order became permanent in 2 cases: one by lapse of time and one by acceptance of an offer of settlement. Six cases were pending at the end of the quarter.

In fiscal 1977 the Commission temporarily suspended 2 exemptions where it had reason to believe there had been noncompliance with the conditions of the regulation or with disclosure standards, or where the exemption was not available for the securities. Added to 6 cases pending at the beginning of the fiscal year, this resulted in a total of 8 cases for disposition. Of these the temporary suspension order became permanent in 6 cases: in 3 by lapse of time, in 2 cases after hearings, and in one by acceptance of an offer of settlement. Two cases were pending at the end of the fiscal year.

On September 29, 1977 the Commission announced the adoption of

Rule 264 and an amendment to its rule governing delegation of authority to Regional Administrators[20] effective October 31, 1977, establishing a procedure whereby the Commission may, in its discretion, determine that a notification on Form 1–A filed pursuant to the Regulation A exemption from the registration requirements of the Securities Act of 1933, as amended, has been abandoned. The Commission may then remove such filings from consideration as pending matters.

Regulation B

Regulation B provides an exemption from registration under the Securities Act for public offerings of fractional undivided interests in oil and gas rights where the initial amount to be raised does not exceed $250,000, provided certain conditions are met. An offering sheet disclosing certain basic and material information of such offering must be furnished to prospective purchasers at least 48 hours in advance of sale of these securities.

Form S–10 is available for the registration of fractional undivided interests in oil and gas rights where the initial amount to be raised exceeds $250,000 or where the exemption is unavailable for any other reason.

During the 1977 fiscal year, 96 offering sheets and 95 amendments thereto were filed pursuant to Regulation B and examined by the Office of Engineering of the Division of Corporation Finance. Sales reported during the year aggregated $7.3 million. In the transition quarter from July through September 1976, 39 offering sheets and 58 amendments were filed, and aggregate sales of $889,551 were reported. During the 1976 fiscal year 365 offering sheets and 462 amendments were filed and examined by the Office of Engineering. Aggregate sales reported during fiscal 1976 were $22.5 million.

In fiscal 1977, the Commission temporarily suspended the Regulation B exemption for one offeror and permanently suspended the exemption for 29 offerors where it had evidence that the offerors had failed to comply with certain requirements. In addition, the exemption was temporarily suspended for one offeror during the transition quarter.

Regulation F

Regulation F provides exemptions from registration for two types of transactions concerning assessable stock. First, an assessment levied upon an existing security holder may be exempted under the regulation, provided the assessable stock is issued by a corporation incorporated under the laws of and having its principal business operations in any State, Territory or the District of Columbia. Regulation F provides an exemption also when assessable stock of any such corporation is sold publicly to realize the amount of an assessment levied thereon, or when such stock is publicly reoffered by an underwriter or dealer. The exemption is available for amounts not exceeding $300,000 per year. The Regulation requires the filing of a notification and other materials describing the offering.

During the transitional quarter, 5 notifications were filed under Regulation F, covering assessments of stock of $174,289. During the 1977 fiscal year, 12 notifications were filed under Regulation F, covering assessments of stock of $444,815, as compared with 15 notifications covering assessments of $356,318 in 1976.

CONTINUING DISCLOSURE: THE SECURITIES EXCHANGE ACT

The Exchange Act contains significant disclosure provisions designed to

provide a fund of current material information on companies in whose securities there is a substantial public interest. The Act also seeks to assure that security holders who are solicited to exercise their voting rights, or to sell their securities in response to a tender offer, are furnished pertinent information.

Over-the-Counter Registration

Section 12(g) of the Exchange Act requires a company with total assets exceeding $1 million and a class of equity securities held of record by 500 or more persons to register those securities with the Commission unless one of the exemptions set forth in that section is available or the Commission issues an exemptive order under Section 12(h). Upon registration, the reporting and other disclosure requirements and the insider trading provisions of the Act apply to these companies to the same extent as to those with securities registered on exchanges.

During the 3 months ended September 30, 1976, 54 registration statements were filed under Section 12(g). Of these, 16 were filed by issuers already subject to the reporting requirements, either because they had another security registered on an exchange or they had registered securities under the Securities Act. During the fiscal year, 231 registration statements were filed under Section 12(g). Of these, 137 were filed by issuers already subject to the reporting requirements, either because they had another security registered on an exchange or they had registered securities under the Securities Act. Included in these figures are companies which succeeded to the businesses of reporting companies and thereby became subject to the reporting requirements.

Registration on Exchanges

Generally speaking, a security cannot be traded on a national securities exchange until it is registered under Section 12(b) of the Exchange Act. If it meets the listing requirements of the particular exchange, an issuer may register a class of securities on the exchange by filing with the Commission and the exchange an application which discloses pertinent information concerning the issuer and its affairs. During the 3 months ended September 30, 1976, a total of 36 issuers listed and registered securities on a national securities exchange for the first time, and a total of 121 registration applications were filed. The registrations of all securities of 9 issuers were terminated. During the fiscal year 1977, a total of 89 issuers listed and registered securities on a national securities exchange for the first time, and a total of 367 registration applications were filed. The registrations of all securities of 113 issuers were terminated. Detailed statistics regarding securities traded on exchanges may be found in Part 9 of the report.

Exemptions

Section 12(h) of the Act authorizes the Commission to grant a complete or partial exemption from the registration provisions of Section 12(g) or from other disclosure and insider trading provisions of the Act where it is not contrary to the public interest or the protection of investors.

There were 27 exemption applications pending on July 1, 1976, and 15 applications were filed between that date and September 30, 1976. Of these 42 applications, 5 were withdrawn, 2 were granted, and 35 applications were pending at the end of the period. For the 1977 fiscal year 35 applications were pending at the beginning of the year, and 56 applica-

tions were filed during the year. Of these 91 applications, 26 were withdrawn, 34 were granted, and 2 denied. Twenty-nine applications were pending at the end of the fiscal year.

Exemptions — Foreign Private Issuers Under Section 12(g)

Foreign private issuers with total assets in excess of $1 million and a class of equity securities held of record by 500 or more persons, of which 300 or more reside in the United States, are subject to the registration, reporting, proxy and insider trading provisions of the Exchange Act of 1934. Notwithstanding, Rule 12g3–2(b) provides an exemption from registration under Section 12(g) of the Act for a foreign issuer which submits material specified in the Rule to the Commission on a current basis. Such required material includes that information about which investors ought reasonably to be informed with respect to the issuer and its subsidiaries and which the issuer (1) has made public pursuant to the law of the country of its domicile or in which it is incorporated or organized, (2) has filed with a stock exchange on which its securities are traded and which was made public by such exchange and/or (3) has distributed to its security holders.

When it adopted Rule 12g3–2 and other rules relating to foreign securities,[21] the Commission indicated that from time to time it would issue lists of those foreign issuers which have obtained exemptions from the registration provisions of Section 12(g) of the Act by providing the information specified in Rule 12g3–2(b). The purpose of the publication of such lists is to call to the attention of brokers, dealers and investors that some form of relatively current information concerning those foreign issuers on the list is available in the public files of the Commission and also that current information concerning other foreign issuers not on the list may not be available in the United States. The latest list was published on August 31, 1977,[22] and includes those foreign private issuers which as of July 31, 1977, appear to be current in furnishing the information under Rule 12g3–2(b). There is a total of 141 foreign private issuers on the list.

Periodic Reports

Section 13 of the Exchange Act requires issuers of securities registered pursuant to Sections 12(b) and 12(g) to file periodic reports keeping current the information contained in the registration application or statement. Similar reports are required pursuant to Section 15(d) of certain issuers which have filed registration statements under the Securities Act which have become effective.

During the 3 months ended September 30, 1976, 13,057 reports — annual, quarterly and current — were filed. In 1977, 45,139 reports — annual, quarterly and current — were filed.

Amendments to Certain Periodic Reports and Related Rules

On January 13, 1977, the Commission adopted amendments to Forms 8–K, 10–Q and 10–K, which are used for current, quarterly and annual reports filed pursuant to section 13 or 15(d) of the Exchange Act and to the disclosure schedule for proxies and information statements.[23]

Although many of the persons who commented on the amendments, which were proposed by the Commission on July 19, 1976,[24] argued that the Form 8–K should be eliminated

and its items transferred to the Form 10-Q, the Commission determined to retain the current report on Form 8-K to assure disclosure of certain matters about which investors might not otherwise receive adequate and reasonably current information. Accordingly, the Form 8-K has been retained to serve as the report for the disclosure of changes in control of the registration, acquisition and disposition of significant amounts of assets, the appointment of a receiver of the registrant in a bankruptcy or similar proceeding[25] and changes in a registrant's certifying accountant. Registrants may also use the form to report certain material events.

In order to assure that the current reports are more timely filed, the amendments require registrants to file reports on Form 8-K within fifteen days after the occurrence of the event reported. Registrants are permitted, however, to request an extension of time in which to file the audited financial statements required in reports of an acquisition of assets; and events which are reported voluntarily by registrants may be described in reports filed within ten days after the end of the month during which such an event occurs.

The remainder of the Form 8-K items have been transferred to the Form 10-Q or eliminated altogether because of sufficient existing requirements in other forms.[26] As a result, generally there was an approximately 62 percent decrease in the number of items of information required to be included in reports on Form 8-K.

The amendments to Form 10-Q provide for a two part report. Part II contains the items which were transferred to the Form 10-Q from the Form 8-K. In addition, two new items permit registrants to disclose other material events on the Form 10-Q and require registrants to state whether any reports on Form 8-K were filed during the quarter. The latter amendment provides users of the reporting system with a convenient reference to determine whether a registrant has filed any reports on Form 8-K. The Form 10-K was also amended to require disclosure about the information encompassed by the items which were transferred to the Form 10-Q that have occurred during the fourth quarter of a registrant's fiscal year.

Substantive amendments of some of the disclosure items were adopted also. The change in control item in the Form 8-K was amended to require additional information including the consideration used by the person(s) which acquired control and descriptions of any arrangements or understandings among the members of both the former and new control group and their associates with respect to election of directors or other matters. In addition, the item requiring disclosure about certain acquisitions and dispositions of assets was amended to require registrants to disclose the source of the funds used for the acquisition. The legal proceedings item and the item relating to disclosure of increases and decreases in outstanding securities in the Form 10-Q were amended to require registrants to describe the disposition of previously reported legal proceedings and to report certain increases and decreases in outstanding indebtedness.

These proposals were adopted because the Commission believed that they would provide for more comprehensive quarterly and annual reports, more timely reporting of events of current importance to investors, reduction of those reports filed on Form 8-K, and substantial savings to registrants and the Commission.

Withdrawal of Proposed Amendments to Forms 10–K and 10–Q

On December 2, 1976 the Commission formally withdrew its proposal to amend Forms 10–K and 10–Q[27] to provide a space on the cover page of each form which a registrant could use to indicate its intent to file a registration statement on Forms S–7, S–9 or S–16.[28] The Commission, however, did adopt a modified version of the proposal in the form of amendments to the General Instructions to Forms S–7, S–16, 10–K and 10–Q. The amendments are in the form of an instruction to each of those forms requesting that the registrant provide the staff with optional notice, by letter, of its intention to file a registration statement on Form S–7 or Form S–16.[29]

Foreign Private Issuer Registration and Annual Report Forms

On December 10, 1976, the Commission announced that it was soliciting the views of the public concerning means of improving the disclosure presently required by Forms 20 and 20–K under the Act.[30] Forms 20 and 20–K are the registration and annual report forms, respectively, authorized for use by certain foreign private issuers under the Act. The Commission indicated that it was considering the possibility of publishing for further comment specific proposals to make Forms 20 and 20–K substantially similar in content to filings on the counterpart Forms 10 and 10–K authorized for use by domestic and certain other North American issuers.

The Commission indicated that its present consideration was prompted in part by the significant differences in the disclosure requirements between those in Forms 20 and 20–K as compared to those in Forms 10 and 10–K. Continual efforts by the Commission to improve disclosures to investors have resulted in material amendments to Forms 10 and 10–K in the past several years. Forms 20 and 20–K, on the other hand, have not been amended since 1967. Additional Commission considerations included the theory that amendments of this nature might not only make the information concerning foreign issuers more meaningful, but also improve the domestic market for foreign securities and thereby facilitate the free flow of capital among nations. It was also suggested that such amendments might reduce, to an extent, any competitive disadvantages reporting domestic issuers possibly suffer in relation to reporting foreign issuers.

In its announcement, the Commission indicated that it was soliciting public views concerning the appropriate approach to be used with respect to disclosures by those foreign issuers which have used or contemplate using the United States capital markets. Of particular interest were public views concerning the desirability, feasibility, and the potential impact on the domestic markets for foreign securities if increased disclosure requirements were made applicable to foreign private issuers.

The comment period for public views on the concept amendment proposals expired March 31, 1977. A total of 54 substantive comment letters were received as a result of the solicitation. The staff of the Division of Corporation Finance completed its review and analysis of the letters of comment and submitted its recommendations to the Commission. At the close of the fiscal year, the Commission was considering the Division's recommendation.

Annual Reports to Security Holders

Based in part on the Industrial Issuers Advisory Report[31] the Commission proposed amendments to its proxy rules in 1974 in order to improve the disclosure in, and dissemination of, annual reports to security holders and to improve the dissemination of annual reports filed with the Commission on Form 10–K.[32]

On October 31, 1974, the Commission amended Rules 14a–3 and 14c–3 under the Exchange Act of 1934[33] to require that annual reports to security holders contain at least the following information: certified financial statements for the last two fiscal years; a summary of operations for the last five fiscal years and management's analysis of the summary with special attention to significant changes occurring during the most recent three years; a brief description of the company's business which, in the opinion of management, indicates the general nature and scope of the company's business; a line of business breakdown of total revenues and of income (or loss) before income taxes and extraordinary items for the last five fiscal years; the name and principal occupation or employment of each director and executive officer of the company; and the market price ranges and dividends paid for each quarterly period during the last two fiscal years with respect to each class of equity securities entitled to vote at the company's annual meeting.

In addition, the new rules require that annual reports to security holders, or the proxy statement, must contain an undertaking that the company will provide, without charge, to any security holder as of the record date, upon written request, a copy of the company's Form 10–K annual report, except for the exhibits thereto, as filed with the Commission. Companies must also undertake to make copies of the exhibits to their Form 10–K available, but companies may impose a fee limited to their reasonable expenses for providing such copies. Finally, these companies will be required: to contact known record holders, such as brokers, banks and their nominees, who may be reasonably expected to hold securities on behalf of beneficial owners; to inquire of them as to the number of sets of material needed for distribution to beneficial owners for whom they hold securities; to furnish the material to them; and to pay the reasonable expenses of the record holders for distributing the material to the beneficial owners.

In furtherance of its responsibility to promote the dissemination of complete information about issuers subject to its jurisdiction, the Commission authorized the publication of a guideline exhibiting policies and practices of its Division of Corporation Finance which permits the integration of the information required by Form 10–K into a company's annual report to shareholders.[34] It is believed that utilization of this procedure will effect a beneficial result for shareholders and issuers alike because the substance of publicly disseminated reports to shareholders should be upgraded and issuers will be able to file one report with the Commission in lieu of two.

Proxy Solicitations

Where proxies are solicited from holders of securities registered under Section 12 or from security holders of registered public-utility holding companies, subsidiaries of holding companies, or registered investment companies, the Commission's proxy regulation requires that disclosure be made of all material facts concerning

the matters on which the security holders were asked to vote and that they be afforded an opportunity to vote "yes" or "no" on any matter other than the election of directors. Where management is soliciting proxies, a security holder desiring to communicate with the other security holders may require management to furnish him with a list of all security holders or to mail his communication for him. A security holder may also, subject to certain limitations, require the management to include in proxy material an appropriate proposal which he wants to submit to a vote of security holders, or he may make an independent proxy solicitation.

Copies of proposed proxy material must be filed with the Commission in preliminary form prior to the date of the proposed solicitation. Where preliminary material fails to meet the prescribed disclosure standards, the management or other group responsible for its preparation is notified informally and given an opportunity to correct the deficiencies in the preparation of the definitive proxy material to be furnished to security holders.

Issuers of securities registered under Section 12 must transmit an information statement comparable to proxy material to security holders from whom proxies are not solicited with respect to a stockholders' meeting.

During the 3 months ended September 30, 1976, 970 proxy statements in definitive form were filed, 938 by management and 2 by nonmanagement groups or individual stockholders. In addition, 30 information statements were filed. The proxy and information statements related to 962 companies and pertained to 898 meetings for the election of directors, 75 special meetings not involving the election of directors, and 12 assents and authorizations.

Aside from the election of directors, the votes of security holders were solicited with respect to a variety of matters, including mergers, consolidations, acquisitions, sales of assets and dissolution of companies (52); authorizations of new or additional securities, modifications of existing securities, and recapitalization plans (90); employee pension and retirement plans (3); bonus or profit-sharing plans and deferred compensation arrangements (40); stock option plans (91); approval of selection by management of independent auditors (472); and miscellaneous amendments to charters and by-laws, and other matters (254).

During the 3 months, 46 proposals submitted by 17 stockholders for action at stockholders' meetings were included in the proxy statements of 27 companies. Typical of such proposals submitted to a vote of security holders were resolutions on amendments to charters or by-laws to provide for cumulative voting for the election of directors, preemptive rights, limitations on the grant of stock options to and their exercise by key employees and management groups and the sending of a post meeting report to all stockholders.

A total of 12 proposals submitted by 8 stockholders were omitted from the proxy statements of 8 companies in accordance with the provisions of the rule governing such proposals. The most common grounds for omission were that the proposals were not proper subjects for stockholders' action under the applicable state law and that the proposals related to the issuer's ordinary business operations.

For the 3 months, 4 companies were involved in proxy contests for the election of directors which bring special requirements into play. In these

contests, 42 persons, including both management and nonmanagement, filed detailed statements required of participants under the applicable rule. Control of the board of directors was involved in 4 instances. Four were pending as of September 30, 1976.

During the 1977 fiscal year, 5,832 proxy statements in definitive form were filed, 5,669 by management and 14 by nonmanagement groups or individual stockholders. In addition, 149 information statements were filed. The proxy and information statements related to 6,278 companies and pertained to 6,235 meetings for the election of directors, 271 special meetings not involving the election of directors, and 39 assents and authorizations.

Aside from the election of directors, the votes of security holders were solicited with respect to a variety of matters, including mergers, consolidations, acquisitions, sales of assets and dissolution of companies (225); authorizations of new or additional securities, modifications of existing securities, and recapitalization plans (541); employee pension and retirement plans (24); bonus or profit-sharing plans and deferred compensation arrangements (327); stock options plans (386); approval of selection by management of independent auditors (3,403) and miscellaneous amendments to charters and by-laws, and other matters (1,547).

During the 1977 fiscal year, 492 proposals submitted by 163 stockholders for action at stockholders' meetings were included in the proxy statements of 268 companies. Typical of such proposals submitted to a vote of security holders were resolutions on amendments to charters or by-laws to provide for cumulative voting for the election of directors, preemptive rights, limitations on the grant of stock options to and their exercise by key employees and management groups and the sending of a post meeting report to all stockholders. In addition, a significant number of proposals relating to social issues were included in management proxy materials. Those proposals related to such subjects as the Arab boycott of Israel, corporate operations in South Africa, corporate political activities and questionable corporate payments abroad, and equal employment opportunities.

A total of 239 proposals submitted by 116 stockholders were omitted from the proxy statements of 122 companies in accordance with the provisions of the rule governing such proposals. The most common grounds for omission were that the proposals were not submitted on time, were not significantly related to the issuer's business, and were related to the issuer's ordinary business operations.

In fiscal 1977, 37 companies were involved in proxy contests for the election of directors which bring special requirements into play. In these contests, 594 persons, including both management and nonmanagement, filed detailed statements required of participants under the applicable rule. Control of the board of directors was involved in 26 instances. In 8 of these, management retained control. Of the remainder, 3 were settled by negotiation, 5 were won by nonmanagement persons, and 10 were pending at year end. In the other 11 cases, representation on the board of directors was involved. Management retained all places on the board in 6 contests; opposition candidates won places on the board in 5 cases.

Takeover Bids, Large Acquisitions

Sections 13(d) and (e), and 14(d), (e) and (f) of the Exchange Act, enacted in 1968 and amended in 1970, provide for full disclosure in cash tender offers and other stock acquisitions in-

volving changes in ownership or control. These provisions were designed to close gaps in the full disclosure provisions of the securities laws and to safeguard the interest of persons who tender their securities in response to a tender offer.

During the transitional quarter, 231 Schedule 13D reports were filed by persons or groups which had made acquisitions resulting in their ownership of more than five percent of a class of securities. Twenty-seven Schedule 13D reports were filed by persons or groups making tender offers (including 3 tender offers filed with the Commission by foreign nationals), which, if successful, would result in more than five percent ownership. In addition, 13 Schedule 14D reports were filed on solicitations or recommendations in a tender offer by a person other than the maker of the offer. One statement was filed for the replacement of a majority of the board of directors otherwise than by a stockholder vote.

During the 1977 fiscal year, 1,098 Schedule 13D reports were filed by persons or groups which had made acquisitions resulting in their ownership of more than five percent of a class of securities. One hundred thirty four reports were filed (on either Schedule 13D or on the new Schedule 14D-1 which went into effect August 31, 1977) by persons or groups making tender offers (including 18 tender offers filed with the Commission by foreign nationals), which, if successful, would result in more than five percent ownership. In addition, 79 Schedule 14D reports were filed on solicitations or recommendations in a tender by a person other than the maker of the offer. Eight statements were filed for the replacement of a majority of the board of directors otherwise than by stockholder vote. One statement was filed under a rule on corporate reacquisitions of securities while an issuer is the target of a cash tender offer.

Rule 14d-2 under the Exchange Act exempts certain communications involved in a tender offer from the provisions of Regulation 14D. Among such communications are those from an issuer to its security holders which do no more than identify the tender offer, state that management is studying the proposal and request the security holders to defer making a decision on the tender offer until they receive management's recommendation. Such recommendations must be made no later than 10 days before expiration of the tender offer, unless the Commission authorizes a shorter period.

Insider Reporting

Section 16 of the Exchange Act and corresponding provisions in the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 are designed to provide other stockholders and investors generally with information on insider securities transactions and holdings and to prevent unfair use of confidential information by insiders to profit from short-term trading in a company's securities.

Section 16(a) of the Exchange Act requires every person who beneficially owns, directly or indirectly, more than 10 percent of any class of equity security which is registered under Section 12, or who is a director or an officer of the issuer of any such security, to file statements with the Commission disclosing the amount of all equity securities of the issuer of which he is the beneficial owner and changes in such ownership. Copies of such statements must be filed with exchanges on which the securities are listed. Similar provisions applicable to insiders of registered public-utility holding companies and registered closed-end in-

vestment companies are contained in the Holding Company and Investment Company Acts.

In connection with insider securities transactions under Section 16 of the Exchange Act, the Commission adopted various amendments to Rules 16b–3 and 16a–6(c) under the Act for the purpose of including certain transactions in stock appreciation rights within the exemptions provided by those rules.[35] The amendments exempt from the reporting requirements of Section 16(a) and the short swing profit recovery provisions of Section 16(b) cash settlements of stock appreciation rights by insiders, provided certain conditions are met. Included among these conditions are requirements relative to the issuer, the rights, and the administration of the plan under which the rights are granted. In addition, the amendments clarify the conditions for the availability of the exemption provided by Rule 16b–3 and make clear the circumstances under which amendments to existing plans must be submitted to an issuer's security holders for approval.

During the 3 months ended September 30, 1976, 21,676 ownership reports were filed. These included 2,607 initial statements of ownership on Form 3, 18,111 statements of changes in ownership on Form 4, and 958 amendments to previously filed reports.

In fiscal 1977, 94,444 ownership reports were filed. These included 10,041 initial statements of ownership on Form 3, 80,001 statements of changes in ownership on Form 4, and 4,402 amendments to previously filed reports.

All ownership reports are made available for public inspection when filed at the Commission's office in Washington and at the exchanges where copies are filed. In addition, the information contained in reports filed with the Commission is summarized and published in the monthly "Official Summary of Security Transactions and Holdings," which is distributed by the Government Printing Office to about 2,197 subscribers.

ACCOUNTING AND AUDITING STANDARDS

The Federal securities laws reflect a recognition by Congress that dependable financial statements of a company are indispensable to informed investment decisions regarding its securities. A major objective of the Commission has been to improve accounting, disclosure, and auditing standards related to financial statements and to assure that high standards of professional independence and conduct are maintained by the public accountants who examine them. The primary responsibility for implementing these objectives rests with the Office of the Chief Accountant of the Commission.

Under the Commission's broad rulemaking power, it has adopted a basic accounting regulation (Regulation S-X) which, together with interpretations and guidelines on accounting and reporting procedures published as Accounting Series Releases, governs the form and content of financial statements filed with the Commission. The Commission has also formulated more specific rules on accounting and auditing of broker-dealers. The accounting rules and releases of the Commission, and its decisions in particular cases, have contributed to clarification of the accounting principles and practices and auditing standards, developed by the accounting profession, generally followed in the preparation of financial statements.

The accounting and financial reporting rules and regulations prescribe

accounting principles to be followed only in certain limited areas. One of the principal ways the Commission protects investors from inadequate or improper financial reporting is to require a report of an independent public accountant, based on an examination of financial statements performed in accordance with generally accepted auditing standards, which expresses an opinion on the financial statements covered by the report and the accounting principles and practices reflected therein. The requirement that the opinion be rendered by an independent public accountant, which was initially established under the Securities Act, is designed to secure the benefits of the detached objectivity and skill of a knowledgeable professional person not connected with management.

The Commission's accounting staff selectively reviews financial statements filed with the Commission for compliance with existing standards and to assure that accounting and auditing standards do not remain static in the face of changes and new developments in financial and economic conditions. New methods of doing business, new types of business, economic changes affecting business generally or industries specifically, the combining of old businesses, the use of new types of securities, and other innovations create accounting problems which require a constant reappraisal of reporting requirements.

Relations With the Accounting Profession

In order to keep abreast of changing conditions, and in recognition of the need for a continuous exchange of views and information between the Commission's accounting staff and outside accountants regarding appropriate accounting and auditing policies, procedures and practices, the staff maintains continuing contact with individual accountants and various professional organizations. The latter include the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB), the principal professional organizations concerned with the development and improvement of accounting and auditing standards and practices. The Chief Accountant also meets regularly with his counterparts in other regulatory agencies to improve coordination on policies and actions among the agencies.

Because of its many foreign registrants and the vast and increasing foreign operations of American companies, the Commission has an interest in the improvement of accounting and auditing principles and procedures on an international basis. To promote such improvement, the Chief Accountant corresponds with foreign accountants, interviews many who visit the country, and, on occasion, participates in foreign and international accounting conferences.

Professional efforts are being made to improve and harmonize accounting standards among countries through various international accounting conferences and committees. One committee, comprised of representatives from approximately thirty-five countries, was established to promulgate international accounting standards. This committee has adopted five standards, has proposed a number of other standards and is developing additional proposals. The Commission will continue to cooperate closely with these committees and groups which have as their long-term objective the development of a coordinated worldwide accounting profession with uniform standards.

The Audit Function

Oversight — Events over the past few years, including major fraud cases brought by the Commission involving false and misleading financial statements, have led to a major reexamination of the role of the accounting profession and the means of achieving and maintaining audits which consistently reflect standards of high quality. The AICPA is the private organization of the profession to which the Commission has historically looked for establishing auditing standards for the profession.

In early 1977 the Commission on Auditors' Responsibilities (Cohen Commission), which had been established by the AICPA in 1974 to study the role and responsibilities of independent auditors, issued its "Report of Tentative Conclusions and Recommendations." This comprehensive report included approximately forty tentative recommendations related to the role of the independent auditor which include: the decisions an auditor must make when he forms an opinion on financial information; reporting on uncertainties; the auditor's responsibility for detecting fraud; the auditor's role in corporate accountability; the boundaries of the auditor's role and its extension; the effectiveness of the auditor's role and its extension; the effectiveness of the auditor's communication with users and the public; the effectiveness of the education, training and development of auditors; the problems associated with the auditor's independence; the process of establishing auditing standards; and the effectiveness of the profession's self-regulation and regulation from outside the profession.

During this year, Congress also took a more active role in examining the accounting profession. The Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce of the House of Representatives, in its October 1976 report, entitled "Federal Regulation and Regulatory Reform", included recommendations concerning the Commission's role in setting accounting and auditing standards, the establishment of adequate systems of internal control, the structure and responsibilities of independent audit committees of corporate boards of directors, and disciplinary actions against accountants.

In January 1977 a staff study entitled "The Accounting Establishment" was issued by the Subcommittee on Reports, Accounting and Management of the Committee on Government Operations of the Senate, and in April, May and June of 1977 this Subcommittee held hearings on accounting and auditing practices and procedures. A major subject under consideration at those hearings was the kind and type of increased regulation needed for the accounting profession and whether Federal legislation is necessary to ensure such regulation.

In September 1977, the AICPA announced the establishment of a new "Division of CPA Firms", an organization designed to carry out reforms which members of the accounting profession have represented that the profession is capable of accomplishing on its own. A Public Oversight Board composed of five individuals of high stature from outside the profession is to oversee the activities of the Division. The Commission has undertaken to report to Congress prior to July 1 of each year on the progress of the Commission and of the profession in responding to the concerns which have been raised about the profession.

Auditor Independence—Financial statements reported on by independent

auditors are, under the Federal securities laws, the keystone to providing investors with reliable financial information. The independence of an auditor is crucial to his effectiveness. Over the past year, the Commission took a number of steps to strengthen auditor independence. In July 1976, the Commission revised Rule 3–16(s) of Regulation S–X to require disclosure in a note to the financial statements of the existence and nature of a previously reported disagreement between a company and its former accountants in those cases in which the successor accountant found acceptable an accounting method which the former accountant found unacceptable.[36] Previously, the Commission had adopted rules which required companies to disclose, in Form 8–K, disagreements between the company and a terminated auditor. The requirements are aimed at strengthening auditor independence by discouraging companies from changing auditors merely to obtain approval of an alternative accounting treatment.

In September 1977, the Commission proposed for public comment amendments to disclosure rules and forms to require disclosure of (1) the reasons for any change of a registrant's independent accountants; and (2) whether the decision was approved by the registrant's Board of Directors or its audit committee.[37] In its release the Commission noted that these proposals accorded with the increased significance of the role of the independent accountant and should aid investors in better understanding and evaluating the registrant's relationship with its independent accountants. The inclusion of audit committees in the proposed rule is indicative of the importance of these committees in the view of the Commission.

As a further aid in strengthening the independence of auditors, the Commission proposed that proxy statements which include selection or ratification of the independent auditors contain information on (1) the nature of services other than examination of financial statements provided during the last fiscal year by the independent auditors and the related fees; (2) whether the board of directors or audit committee approved all services; and (3) the company's revenues derived from the independent auditors.[38]

These proposed amendments are one way in which the Commission has encouraged the formation of audit committees comprised of independent members of the Board of Directors. The Commission strongly favors such committees, which can serve as links between independent accountants and shareholders for the discussion of matters pertinent to the examination of the financial statements. In furtherance of these objectives, the Commission believes that one of the principal responsibilities of an independent audit committee should be that of recommending the engagement or discharge of the company's independent accountants to the shareholders or the full Board of Directors.

In recognition of the disagreement and concern over whether and what types of services offered by accountants result in a lessening of the independence or the appearance of independence of auditors, the Commission solicited information and comment on the nature of services auditors provide their audit clients.[39]

The Accounting Function

FASB—The FASB is an independent private body which establishes standards of financial accounting and presentation for the guidance of issuers of financial statements and public accountants who examine such

statements. The FASB provides leadership to the profession in establishing and improving accounting principles and standards, and the Commission expects that the FASB's conclusions will promote the interests of investors. Unless the Commission has expressed a view to the contrary, it considers the statements of the FASB to be substantial authoritative support for an accounting practice or procedure.

The Financial Accounting Foundation, an organization sponsored by a number of leading organizations which represent various aspects of the accounting, securities, banking, academic, financial and other professions, appoints the seven members of the FASB and the members of the advisory council to the FASB. In the past year, the Structure Committee of the Financial Accounting Foundation, after reviewing the operations of the FASB, published a report containing a number of recommendations to increase the effectiveness of the FASB, many of which have been implemented.

As of September 30, 1977, the FASB had issued 16 Statements of Financial Accounting Standards and 18 Interpretations relating to accounting opinions or standards. In addition, it had under active consideration a heavy agenda of technical projects which included: conceptual framework for accounting and reporting; financial accounting and reporting in the extractive industries; criteria for determining materiality; interim financial reporting; business combinations and purchased intangibles; accounting for interest costs; accounting and reporting for employee benefit plans; and classification of preferred stock. It had held public hearings on many of the projects and had issued exposure drafts of certain proposed statements.

The FASB has appointed a permanent screening committee to assist it in identifying emerging practice problems, evaluating their magnitude and urgency, and assessing priorities for their resolution. The Chief Accountant and the FASB maintain liaison procedures for consultation on projects of either the Board or the SEC which are of mutual interest.

When the FASB issues improved standards of accounting and financial reporting, the Commission revises its rules and regulations to co-ordinate with the improved standards. In August 1977, the Commission amended Rule 3–16 of Regulation S–X to conform its lease accounting and disclosure requirements to those standards adopted by the FASB in its Statement No. 13, "Accounting for Leases" to require that financial statements filed with the Commission for fiscal years ending after December 24, 1978 reflect such requirements and to require certain lease disclosures of rate-regulated enterprises.[40]

In May 1977, the Commission published for comment proposals for revisions of certain disclosure forms and rules relating to industry and homogeneous geographic segment reporting. These proposals were intended to coordinate the Commission's line-of-business information with FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise" and to avoid unnecessary duplication resulting from compliance with this statement. In certain instances the proposals would require additional information, such as intersegment sales and transfers, beyond the requirements of the FASB. The proposals would require registrants to provide detailed descriptions of industry segments in which they engage in business, as well as five year financial information relating to industry segments and foreign and domestic operations. In connection with these pro-

posals, the Commission also sought comment on proposed Form S–K, a new integrated disclosure form.[41]

Oil and Gas Accounting—The Energy Policy and Conservation Act of 1975 (EPCA) authorized the Commission to take such steps as may be necessary to assure the development and observance of accounting to be followed by companies engaged in the production of crude oil or natural gas. In carrying out these responsibilities, the Commission is required to consult with the Department of Energy, the General Accounting Office and the Federal Energy Regulatory Commission. The Commission is authorized to rely on accounting practices developed by the FASB if the Commission is assured that such practices would be observed to the same extent as if the Commission had prescribed such practices by rule.

In June 1977, the Commission solicited public comment on matters relating to the reporting of financial and operating data on oil and gas operations pursuant to the EPCA and to the disclosure of such data in filings with the Commission pursuant to the Federal securities laws.[42] In July 1977, the FASB issued an exposure draft of a proposed "Statement on Financial Accounting and Reporting by Oil and Gas Producing Companies." In the exposure draft the FASB proposed that oil and gas production companies should follow a form of the successful efforts method of accounting and that, among other things, companies should disclose information on quantities of oil and gas reserves and certain related data in their financial statements.

In August and October 1977, the Commission proposed rules for public comment pursuant to the EPCA and the Federal securities laws.[43] These proposed rules were substantially the same as those contained in the FASB exposure draft except that they required certain data in addition to those proposed in the FASB's statements.

Replacement Cost Disclosure—In December, 1976, the Commission amended Rule 3–17 of Regulation S–X, the rule which requires disclosure of certain replacement cost data, to state that liability for disclosures of replacement cost data may be imposed only in instances in which it can be shown that the disclosures were prepared without a reasonable basis or were disclosed in other than good faith. The Commission took this action in recognition of the imprecise nature of replacement cost information and in order to encourage the development and disclosure of such information.[44]

In August 1977 the Commission, noting that significant effort has been expended by registrants, public accounting firms and industry groups to provide meaningful replacement cost disclosures, requested public comment on experience with problems which have arisen in implementing Rule 3–17. The Commission also indicated its plans to engage in a general evaluation of experiences with the replacement cost rule during 1978.[45]

Establishment of Accounting Principles—In July 1976, the public accounting firm of Arthur Andersen & Co. (Andersen) brought suit against the Commission in the United States District Court for the Northern District of Illinois to enjoin the Commission from enforcing compliance with (1) Instructions H(f) of Form 10–Q which requires that independent accountants express their judgment regarding the preferability of an accounting principle adopted when accounting principles are changed at the discretion of a registrant; and (2) the statement of policy embodied in Accounting Series Release No. 150 in which the

Commission stated that it would consider accounting principles, standards and practices promulgated by the FASB as having substantial authoritative support and those contrary to such FASB promulgations as having no support.

Andersen's motion for a restraining order, *pendente lite*, was denied on August 13, 1976, and its motion for a preliminary injunction was denied on September 3, 1976. On October 4, 1976, the Commission filed a motion for summary judgment, or, alternatively, to dismiss the action on the basis that (1) Accounting Series Release No. 150 is not a substantive rule but is merely a statement of Commission policy, and as such does not constitute any delegation of Commission authority to any person and was properly issued; (2) Instruction H(f) is a proper exercise of the Commission's broad authority to adopt accounting rules; and (3) Andersen lacks standing to pursue the issues raised. This motion remains pending.

Disciplinary Matters

During the period July 1, 1976 to September 30, 1977, the Commission issued twenty-two orders imposing disciplinary sanctions on public accountants pursuant to the Commission's Rules of Practice. Professional accountants were also the subject of a number of enforcement proceedings alleging misconduct in connection with audit examinations or the preparation of financial statements. (See Part 4 for a discussion of significant accounting proceedings).

Staff Accounting Bulletins

The Division of Corporation Finance and the Office of Chief Accountant issued eight Staff Accounting Bulletins during the year. The statements in these bulletins are not rules or interpretations of the Commission, nor do they bear the Commission's official approval; they represent interpretations and practices followed by the staff in reviewing financial statements and administering the requirements of the federal securities laws. These bulletins included interpretations regarding disclosure of replacement cost, interim financial reporting, disclosure of holdings of New York City securities, allowance for funds used during construction, and data relating to FASB Statement No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies."

EXEMPTIONS FOR INTERNATIONAL BANKS

Section 15 of the Bretton Woods Agreement Act, as amended, exempts from registration securities issued, or guaranteed as to both principal and interest, by the International Bank for Reconstruction and Development. The Bank is required to file with the Commission such annual and other reports on securities as the Commission determines to be appropriate. The Commission has adopted rules requiring the Bank to file quarterly reports and copies of annual reports of the Bank to its Board of Governors. The Bank is also required to file advance reports of any distribution in the United States of its primary obligations. The Commission, acting in consultation with the National Advisory Council on International Monetary and Financial Problems, is authorized to suspend the exemption for securities issued or guaranteed by the Bank. Except where otherwise indicated, all amounts that follow are expressed in U.S. dollar equivalents as of June 30, 1977.

Net income for the year was $209 million, compared with $220 million the previous year. Of the $209 million net income earned in the fiscal year ended June 30, 1977, the Executive

Directors of the Bank in July 1977 approved the allocation of $109 million to the General Reserve and recommended to the Board of Governors of the Bank that the balance of $100 million be transferred by way of grant to the International Development Association.

Repayments of principal on loans received by the Bank during the year amounted to $709 million, and a further $64 million was repaid to purchasers of portions of loans. Total principal repayments by borrowers through June 30, 1977, aggregated $8.0 billion, including $5.7 billion repaid to the Bank and $2.3 billion repaid to purchasers of borrowers' obligations sold by the Bank.

Outstanding borrowings of the Bank were $18.5 billion at June 30, 1977. During the year, the Bank borrowed $650 million through the issuance of 2-year U.S. dollar bonds to central banks and other governmental agencies in some 80 countries; $1,850 million in the United States; DM 3,400 million (U.S. $1,394.1 million) in the Federal Republic of Germany; 2.0 billion yen ($7.0 million) in Japan; SwF 1,250 million (U.S. $502.5 million) in Switzerland; SwF 75 million (U.S. $29.5 million) and $150 million in Saudi Arabia; $100 million in Yugoslavia; and $37.5 million from the Interest Subsidy Fund, which is administered by the Bank. The Fund, which obtained its resources from voluntary contributions from member governments, was established to subsidize the interest payments to the Bank on loans made to poorer developing countries.

These borrowings, in part, refunded maturing issues amounting to the equivalent of $916 million. After retirement of $78 million equivalent of obligations through sinking fund and purchase fund operations, the Bank's outstanding borrowings showed a net increase of $3,831 million from the previous year after adding $566 million representing adjustment of borrowings as a result of currency depreciations and appreciations in terms of U.S. dollars of the value of the non-dollar currencies in which the debt was denominated.

The Inter-American Development Bank Act, which authorizes the United States to participate in the Inter-American Development Bank, provides an exemption for certain securities which may be issued or guaranteed by the Bank similar to that provided for securities of the International Bank for Reconstruction and Development. Acting pursuant to this authority, the Commission adopted Regulation IA, which requires the Bank to file with the Commission substantially the same type of information, documents and reports as are required from the International Bank for Reconstruction and Development. The following data reflect information submitted by the Bank to the Commission.

On September 30, 1976, the outstanding funded debt of the Ordinary Capital resources of the Bank was the equivalent of $1.927 billion, reflecting a net increase during the transition quarter of the equivalent of $111 million. During such quarter, the funded debt increased through a public offering in the United States of $100 million and private placements in Trinidad and Tobago for $15 million and in Germany for the equivalent of $19.6 million. In addition, there were drawings totalling $5.9 million under arrangements with Japan and the United Kingdom. The funded debt decreased by approximately $14.5 million due to downward adjustment of the U.S. dollar equivalent of borrowings denominated in non-regional currencies. The funded debt also decreased through the retirement

of approximately $15.3 million from sinking fund purchases and scheduled debt retirement.

On September 30, 1977, the outstanding funded debt of the Ordinary Capital resources of the Bank was the equivalent of $2.246 billion, reflecting a net increase in the past year of the equivalent of $319 million. During the year the funded debt increased through a public offering in the United States of $100 million; public offerings in Austria and Germany for the equivalent of $16.3 million and $39.2 million, respectively; the Bank's first public offerings in Japan and Trinidad and Tobago for the equivalent of $56.2 million and $10.4 million, respectively; a public offering and a private placement in Switzerland totalling the equivalent of $93.9 million; as well as a private placement in Italy for $15 million. In addition, there were drawings totalling $277 million under arrangements with Finland, Japan and the United Kingdom. Additionally, $73.9 million of two-year bonds were sold to Latin American and Caribbean Central Banks or Governmental Agencies, essentially representing a roll-over of a maturing borrowing of $54.1 million and an increase in short-term funded debt of $19.8 million. The funded debt increased by approximately $43 million due to upward adjustment of the U.S. dollar equivalent of borrowings denominated in non-regional currencies. The funded debt decreased through the retirement of approximately $78.2 million from sinking fund purchases and scheduled debt retirement.

The Asian Development Bank Act, adopted in March 1966, authorized United States participation in the Asian Development Bank and provides an exemption for certain securities which may be issued or guaranteed by the Bank, similar to the exemptions accorded the International Bank for Reconstruction and Development and the Inter-American Development Bank. Acting pursuant to this authority, the Commission has adopted Regulation AD which requires the Bank to file with the Commission, documents and reports as are required from those banks. The Bank has 42 members with subscriptions totaling $6.95 billion.

From July 1, 1976 through September 30, 1976, the Bank's net borrowings totaled the equivalent of $108 million. Through fiscal 1977, the Bank's net borrowings totaled the equivalent of $1,151 million. From July 1, 1976 through September 30, 1976, the Bank issued obligations of the equivalent of $32.6 million in Switzerland and for fiscal 1977, the Bank issued obligations of the equivalent of $42 million in Germany. From July 1, 1976 through September 30, 1976, borrowing in the United States was $75 million at 8.625 percent; and for fiscal 1977, borrowing in the United States was $70 million at 6.5 percent (2 year).

As of September 30, 1977, 14 countries have contributed or pledged a total of $486.1 million to the original source mobilization of the Bank's concessionary loans fund. A total of $57.4 million from Ordinary Capital resources has been set aside by the Board of Governors for concessionary loan purposes. Congress appropriated a $25 million contribution during fiscal 1977, bringing U.S. contributions to $150 million. As of the same date, pledges from donor countries for replenishment of the Bank's concessional loan funds amounted to an additional $580.96 million. The total to be contributed could amount to $809.16 million.

TRUST INDENTURE ACT OF 1939

This Act requires that bonds, debentures, notes and similar debt securities offered for public sale, except as specifically exempted, be issued under an indenture which meets the requirements of the Act and has been duly qualified with the Commission.

The provisions of the Act are closely integrated with the requirements of the Securities Act. Registration pursuant to the Securities Act of securities to be issued under a trust indenture subject to the Trust Indenture Act is not permitted to become effective unless the indenture conforms to the requirements of the latter Act, designed to safeguard the rights and interests of the purchasers. Moreover, specified information about the trustee and the indenture must be included in the registration statement.

The Act was passed after studies by the Commission had revealed the frequency with which trust indentures failed to provide minimum protections for security holders and absolved so-called trustees from minimum obligations in the discharge of the trusts. It requires, among other things, that the indenture trustee be a corporation with a minimum combined capital and surplus and be free of conflicting interests which might interfere with the faithful exercise of its duties on behalf of the purchasers of the securities, and it imposes high standards of conduct and responsibility on the trustee.

During the three months ended September 30, 1976, 83 trust indentures relating to securities in the aggregate amount of $4 billion were filed. During fiscal year 1977, 358 trust indentures relating to securities in the aggregate amount of $24.63 billion were filed.

INFORMATION FOR PUBLIC INSPECTION: FREEDOM OF INFORMATION ACT

On November 21, 1974, Congress passed over President Ford's veto amendments to the Freedom of Information Act.[46] which significantly changed the procedures governing the handling of requests made pursuant to the Freedom of Information Act (5 U.S.C. 552) as well as the scope of certain of the exemptions from Act's provisions. These amendments became effective February 19, 1975. The Commission amended its rules under the Freedom of Information Act (17 CFR 200.80)[47] to reflect the amended provisions of the Freedom of Information Act; these rules specify the categories of available materials and those categories of records that are generally considered nonpublic. These rules establish the procedure to be followed in requesting records or copies and provide for a method of administrative appeal from the denial of access to any record. They also provide for the imposition of duplicating fees and search fees when more than one-half man-hour of work is performed by the Commission's staff to locate and make records available. In addition to the records described, the Commission makes available for inspection and copying all requests for no-action and interpretive letters received after December 31, 1970, and responses thereto (17 CFR 200.80). Also made available since November 1, 1972 are materials filed under Proxy Rule 14a–8(d), which deals with proposals offered by shareholders for inclusion in management proxy-soliciting materials, and related materials prepared by the staff (17 CFR 200.82).

Following the effective date of the amendments to the Freedom of In-

formation Act, the Commission instituted the practice of issuing a public release, in a series designated Freedom of Information Act Releases, in most administrative appeals decided under the Act. The Commission hopes that this series of releases will serve to inform the public as to its disclosure policies under the Freedom of Information Act and of the manner in which it has interpreted and applied the Act to the many types of records maintained by the Commission.

Exemption 3 of the Freedom of Information Act was amended by the Congress when it enacted the "Government in the Sunshine" Act[48] in order to conform FOIA Exemption 3 to the analogous exemption contained in the Sunshine Act. Previously, the FOIA exemption had applied to any matter "specifically exempted from disclosure by statute."[49] The purpose of the amendment, the Conference Report on the Sunshine Act states, is to overrule the decision of the Supreme Court in *Administrator, FAA v. Robertson,*[50] in which the Court approved withholding under a statute which gave an agency discretion to withhold matters where it determined that disclosure was not "in the public interest."[51] As a result, statutes which contain only a "public interest" standard no longer serve as statutory authorization under these exemptive provisions. This amendment did not substantially affect the Commission, however, since Section 24 of the Exchange Act, as amended by the 1975 Securities Acts Amendments (which applies to all records in the Commission's possession, however obtained), already had the effect of limiting Commission discretion to withhold records "in the public interest."

Most of the administrative appeals decided by the Commission are concerned with investigatory records. The seventh exemption of the Act, as amended, provides that the Freedom of Information Act "does not apply" to such records to the extent that their production would "interfere with enforcement proceedings," "deprive a person of a right to a fair trial or an impartial adjudication," "constitute an unwarranted invasion of personal privacy," or cause other types of harm specifically enumerated in the exemption. The Commission, in the administrative appeals it has decided, has determined that investigatory records will generally be withheld on the ground that production will "interfere with enforcement proceedings" only if judicial or administrative proceedings brought by the Commission or other law enforcement authorities are in progress or there is a concrete prospect that law enforcement proceedings will be instituted.[52] Evidentiary materials contained in investigatory files closed after the completion of public law enforcement proceedings will generally be available to any person requesting access to them.[53] In those cases where investigations are closed by the Commission without the institution of public enforcement action, the Commission has recognized that considerations of personal privacy often require that such records not be disclosed to members of the public,[54] except where a demonstration of particularized need for access to the records sufficient to outweigh considerations of personal privacy has been made.[55]

Registration statements, applications, declarations, and annual and periodic reports filed with the Commission each year, as well as many other public documents, are available for public inspection and copying at the Commission's public reference room in its principal offices in

Washington, D.C. and, in part, at its regional and branch offices.

The Commission has special public reference facilities in the New York, Chicago and Los Angeles Regional Offices and some facilities for public use in other regional and branch offices. Each regional office has available for public examination copies of prospectuses used in recent offerings of securities registered under the Securities Act; registration statements and recent annual reports filed under the Exchange Act by companies having their principal office in the region; recent annual reports and quarterly reports filed under the Investment Company Act by management investment companies having their principal office in the region; broker-dealer and investment adviser applications originating in the region; letters of notification under Regulation A filed in the region, and indices of Commission decisions.

During the Transitional Quarter and the 1977 fiscal year, over 25,000 persons examined material on file in Washington (4,812 from July 1, 1976, through September 30, 1976, and 20,899 from October 1, 1976, through September 30, 1977); several thousand others examined files in New York, Chicago, Los Angeles, and other regional offices. More than 69,000 searches were made for information requested by individuals (12,260 from July 1, 1976, through September 30, 1976, and 57,213 from October 1, 1976, through September 30, 1977); and approximately 19,000 letters were received for information and/or documents (3,423 from July 1, 1976, through September 30, 1976, and 15,376 from October 1976, through September 30, 1977).

The public may make arrangements through the Public Reference Section of the Commission in Washington, D.C. to purchase copies of material in the Commission's public files. The copies are produced by a commercial copying company which supplies them to the public at prices established under a contract with the Commission. Current prices begin at 10 cents per page for pages not exceeding 8½" × 14" in size, with a $3.50 minimum charge. Under the same contract, the company also makes microfiche and microfilm copies of Commission public documents available on a subscription or individual order basis to persons or firms who have or can obtain viewing facilities. In microfiche services, up to 60 images of document pages are contained on 4" × 6" pieces of film, referred to as "fiche."

Annual microfiche subscriptions are offered in a variety of packages covering all public reports filed on Forms 10–K, 10–Q, 8–K, N–1Q and N–1R under the Securities Exchange Act or the Investment Company Act; annual reports to stockholders; proxy statements; new issue registration statements; and final prospectuses for new issues. The packages offered include various categories of these reports, including those of companies listed on the New York Stock Exchange, the American Stock Exchange, regional stock exchanges, or traded over-the-counter. Reports are also available by standard industry classifications. Arrangements also may be made to subscribe to reports of companies of one's own selection. Over one hundred million pages (microimagery frames) are being distributed annually. The subscription services may be extended to further groups of filings in the future if demand warrants. The copying company will also supply copies in microfiche or microfilm form of other public records of the Commission desired by a member of the public.

Microfiche readers and reader-print-

ers have been installed in the public reference areas in Washington, D.C. and the New York, Chicago, and Los Angeles regional offices, and sets of microfiche are available for inspection there. Visitors to the public reference room in Washington, D.C. may also make immediate reproduction of material on photostatic-type copying machines. The cost to the public of copies made by use of all customer-operated equipment is 10 cents per page. The charge for an attestation with the Commission seal is $2. Detailed information concerning copying services available and prices for the various types of services and copies may be obtained from the Public Reference Section of the Commission.

FREEDOM OF INFORMATION ACT LITIGATION

In *Harnett, et al. v. SEC, et al.*,[56] Joel Harnett, a candidate in New York City's mayoral election campaign, sought the disclosure of draft portions of a staff report of investigation into certain transactions in the securities of the City of New York.[57] Even though the plaintiffs had not made a formal FOIA request for the draft portions of the report and, accordingly, the Commission was never afforded an opportunity to consider the matter, the United States District Court ordered the Commission to submit the report to it for *in camera* inspection.[58] Since the records were clearly exempt from compelled disclosure pursuant to Exemptions 5 and 7 of the FOIA, and since production for *in camera* inspection would have disrupted unnecessarily the Commission's ongoing investigation, the Commission secured a stay of the District Court's order pending review by the Court of Appeals or, alternatively, consideration of the Commission's petition for a writ of mandamus. The action was subsequently rendered moot, however, when the staff's completed report was issued on August 26, 1977,[59] although the demands of both the plaintiffs and the Commission for costs, including reasonable attorneys' fees, have yet to be resolved by the district court.

In *Continental Stock Transfer and Trust Co. v. SEC*,[60] a stock transfer agent registered with the Commission sought review of a Commission order pursuant to Rule 24b–2 under the Exchange Act,[61] denying Continental's request for confidential treatment of the list of the names of the issuers of securities for which it acted as a transfer agent. Continental claimed that the information in question, which was required to be submitted pursuant to Form TA–1, was exempt from disclosure as "confidential commercial information" under Exemption 4 of the Freedom of Information Act. The Commission, in denying the request for confidential treatment, cited the facts that (1) the information in question was already publicly available, although some research was necessary to compile it, and (2) other transfer agents in positions similar to that of Continental had filed comparable information with the Commission without making any claim of competitive disadvantages.

On March 21, 1977, the Court of Appeals for the Second Circuit affirmed the Commission's order. In its opinion, the court adopted for the Second Circuit the test formulated by the District of Columbia Circuit for determining what information is within the scope of Exemption 4.[62] Applying that test, the court ruled that disclosure of the information in question was neither likely to impair the government's ability to obtain similar information in the future or to cause substantial harm to Continental's competitive position. In this latter regard, the court noted that it

found persuasive the fact that almost all of the information disclosed by Continental was already available to the public through various reference works.

Canadian Pacific Ltd. v. SEC[63] also involved a petition for review of a Commission order entered pursuant to Rule 24b–2 under the Exchange Act. The information in issue in that case was data regarding the remuneration which Canadian Pacific Limited, a diversified Canadian corporation, paid to its three highest paid officers. The information was required to be filed with the Commission pursuant to the Commission's rules relating to proxy solicitations and, unless granted confidential treatment by the Commission, was required to be disseminated by Canadian Pacific to its shareholders.

The Commission, in response to the request of the corporation, did grant confidential treatment for the remuneration information pertaining to the three years in issue in this case, 1974 through 1976. Upon consideration of a request for access to this information under the Freedom of Information Act, however, the Commission determined that the FOIA required the Commission to honor the request and, accordingly, entered an order suspending the three prior orders granting confidential treatment, which had been entered by the staff pursuant to delegated authority.

In petitioning the court of appeals for review of the Commission's order, the company claimed that the information was exempt pursuant to Exemptions 4 and 6 of the Freedom of Information Act, relating to confidential commercial information and to information the disclosure of which would result in a clearly unwarranted invasion of personal privacy. In addition, the company raised certain procedural objections to the Commission's order. After the issues had been fully briefed in the court of appeals, the company, on February 28, 1978, elected to dismiss the pending petition for review, and the information was disclosed to the party requesting access to it.

NOTES TO PART 2

[1]Securities Act Release No. 5231 (February 3, 1972).

[2]Securities Act Release No. 5767 (November 22, 1976), 10 SEC Docket 983. Corrected in Securities Act Release No. 5767A (December 17, 1976), 11 SEC Docket 1200.

[3]Securities Act Release No. 5723 (July 2, 1976), 9 SEC Docket 1014.

[4]Securities Act Release No. 5791 and Securities Exchange Act Release No. 13083 (December 20, 1976), 11 SEC Docket 1205.

[5]The amendments were proposed in Securities Act Release No. 5728 (July 26, 1976), 10 SEC Docket 92.

[6]The Commission announced that it is considering amendments to Form S–16 to allow its use in certain primary offerings. *See* Securities Act Release No. 5792 (December 20, 1976), 11 SEC Docket 1214.

[7]Securities Act Release No. 5744 (September 27, 1976), 10 SEC Docket 574.

[8]A proposed amendment to Securities Act Rule 429 (a) would make the rule unavailable if the issuer's latest registration statement was filed on Form S–14A. Proposed amendments to Rules 14a–3, 14a–6, 14a–11, 14a–12, 14c–2 and 14c–5 under the Exchange Act provided that material filed in a Form S–14A registration statement would satisfy the informational and filing requirements of the proxy or information rules under Section 14 of the Exchange Act.

[9]Securities Act Release No. 5806 (February 16, 1977), 11 SEC Docket 1716.

[10]Securities Act Release No. 5487 (April 23, 1974), 4 SEC Docket 154.

[11]Securities Act Release No. 5779 (December 6, 1976), 11 SEC Docket 1116.

[12]Securities Act Release No. 5822 (April 18, 1977), 12 SEC Docket 4.

[13]Securities Act Release No. 5865 (September 16, 1977), 13 SEC Docket 107.

[14]Securities Act Release No. 5750 (October 8, 1976), 10 SEC Docket 691.

[15]Securities Act Release No. 5745 (September 27, 1976), 10 SEC Docket 586.

[16]Securities Act Release No. 5834 (June 13, 1977), 12 SEC Docket 814.

[17]Securities Exchange Act Release No. 13190 (January 19, 1977), 11 SEC Docket 1525.

[18]Securities Act Release No. 5811 (February 28, 1977), 11 SEC Docket 1864.

[19]Securities Act Release No. 5842 (July 5, 1977), 12 SEC Docket 1099.
[20]Securities Act Release No. 5871 (September 29, 1977), 13 SEC Docket 226.
[21]Securities Exchange Release No. 8066 (April 28, 1967).
[22]Securities Exchange Act Release No. 13913 (August 31, 1977), 12 SEC Docket 1642.
[23]Securities Exchange Act Release No. 13156 (January 13, 1977), 11 SEC Docket 1425.
[24]Securities Exchange Act Release No. 12619 (July 19, 1976), 10 SEC Docket 15.
[25]This is a new requirement in the Form 8-K which was adopted because the Commission believes that the availability of this information in the Commission's files will be useful to investors.
[26]The following items of information were transferred to the Form 10-Q: Legal Proceedings, Changes in Securities, Changes in Security for Registered Securities, Defaults upon Senior Securities, Increase and Decrease in Outstanding Securities, and Submission of Matters to a Vote of Security Holders. Two other items of information were eliminated altogether: Options to Purchase Securities and Extraordinary Item Charges and Credits.
[27]See Securities Act Release No. 5715 (June 2, 1976), 9 SEC Docket 760, for the text of the withdrawn proposal.
[28]Securities Act Release No. 5776 (December 2, 1976), 11 SEC Docket 1051.
[29]Securities Act Release No. 5777 (December 2, 1976), 11 SEC Docket 1051.
[30]Securities Exchange Act Release No. 13056 (December 10, 1976), 11 SEC Docket 1172.
[31]See 39th Annual Report, pp. 16-17.
[32]Securities Exchange Act Release No. 10591 (January 10, 1974), 3 SEC Docket 359. See 40th Annual Report, pp. 15-16.
[33]Securities Exchange Act Release No. 11079 (October 31, 1974), 5 SEC Docket 356.
[34]Securities Exchange Act Release No. 13639 (June 17, 1977), 12 SEC Docket 918.
[35]Securities Exchange Act Release No. 13097 (December 22, 1976), 11 SEC Docket 1269; Securities Exchange Act Release No. 13385 (March 17, 1977), 11 SEC Docket 2008; Securities Exchange Act Release No. 13659 (June 22, 1977), 12 SEC Docket 935.
[36]Accounting Series Release No. 194 (July 18, 1976), 10 SEC Docket 100.
[37]Securities Act Release No. 5868 (September 26, 1977), 13 SEC Docket 218.
[38]Securities Act Release No. 5869 (September 26, 1977), 13 SEC Docket 221.
[39]*Ibid.*
[40]Accounting Series Release No. 225 (August 31, 1977), 12 SEC Docket 1612.
[41]Securities Act Release No. 5826 (May 10, 1977), 12 SEC Docket 340.
[42]Securities Act Release No. 5837 (June 20, 1977), 12 SEC Docket 900.
[43]Securities Act Release Nos. 5861 (August 31, 1977), 12 SEC Docket 1617, 5877 (October 26, 1977), 13 SEC Docket 416, 5878 (October 26, 1977), 13 SEC Docket 434.
[44]Accounting Series Release No. 203 (December 9, 1976), 11 SEC Docket 1162.
[45]Securities Act Release No. 5848 (August 5, 1977), 12 SEC Docket 1458.
[46]Pub. L. No. 93-502.
[47]Securities Act Release No. 5571 (February 21, 1975), 6 SEC Docket 286.
[48]P.L. 94-409. The "Government in the Sunshine" Act is codified at 5 U.S.C. 552b.
[49]5 U.S.C. 552 (b) (3).
[50]442 U.S. 255 (1975).
[51]H. R. Rep. No. 94-1441, 94th Congress., 2d Sess. 25 (1976).
[52]See, *e.g., In the Matter of Request of I. Walton Bader,* FOIA Release No. 1 (April 3, 1975), 6 SEC Docket 541; *In the Matter of Request of Jeffrey B. Albert,* FOIA Release No. 10 (June 11, 1975), 7 SEC Docket 138.
[53]Securities Act Release No. 5571 (February 21, 1975), 6 SEC Docket 288. *In the Matter of Request of John A. Jenkins,* FOIA Release No. 11 (June 11, 1975), 7 SEC Docket 139.
[54]*In the Matter of Request of John A. Jenkins,* FOIA Release No. 11 (June 11, 1975), 7 SEC Docket 139.
[55]*In the Matter of Request of Jung Ja Malandris,* FOIA Release No. 8 (May 29, 1975), 7 SEC Docket 58.
[56]S.D.N.Y., No. 77 Civ. 3110 (VLB); C.A. 2, No. 77-6124.
[57]The report was prepared and issued pursuant to Section 21(a) of the Securities Exchange Act, 15 U.S.C. 78u(a).
[58]5 U.S.C. 522(a) (4) (B).
[59]Securities and Exchange Commission, *Staff Report on Transactions in Securities of the City of New York,* Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess. (Comm. Print, 1977).
[60]C.A. 2, No. 77-4034; CCH Fed. Sec. L. Rep. para. 96,172 (March 21, 1977).
[61]17 CFR 240.24b-2.
[62]*See, e.g., Charles River Park "A", Inc. v. Department of Housing and Urban Development,* 519 F.2d 935 (C.A.D.C., 1975).
[63]C.A.D.C., No. 77-1587.

Part 3
Regulation of Securities Markets

Part 3
Regulation of Securities Markets

In addition to the disclosure provisions discussed in the preceding chapter, the Securities Exchange Act of 1934 (Exchange Act), as amended by the Securities Acts Amendments of 1975 (the 1975 Amendments),[1] assigns to the Commission broad regulatory responsibilities over the securities markets, the self-regulatory organizations within the securities industry and persons conducting a business in securities. Among other regulatory responsibilities, the Exchange Act directs the Commission to facilitate the establishment of a national market system for securities and a national system for the clearance and settlement of securities transactions. The Exchange Act requires registration of securities exchanges and certain clearing agencies, permits registration of associations of brokers or dealers, established the Municipal Securities Rulemaking Board (MSRB), as a self-regulatory organization, to formulate rules for the municipal securities industry, and provides for Commission supervision of the self-regulatory responsibilities of national securities exchanges, registered clearing agencies, registered securities associations and the MSRB. The Exchange Act also requires the registration of securities brokers and dealers, certain municipal securities professionals, securities information processors, and transfer agents. Finally, the Exchange Act contains provisions designed to prevent fraudulent, deceptive and manipulative acts and practices on the exchanges and in the over-the-counter markets. Important recent developments concerning regulation of the securities markets are discussed in Part 1 of this Annual Report.

REGULATIONS OF EXCHANGES

Registration

The Exchange Act generally requires a securities exchange to register with the Commission as a national securities exchange unless the Commission, acting pursuant to Section 5 of the Exchange Act, exempts it from registration because of the limited volume of its transactions. As of September 30, 1977, the following ten securities exchanges were registered with the Commission: American Stock Exchange, Inc.; Boston Stock Exchange, Incorporated; Chicago Board Options Exchange, Incorporated; Cincinnati Stock Exchange; Intermountain Stock Exchange; Midwest Stock Exchange, Incorporated; New York Stock Exchange, Inc.; Pacific Stock Exchange, Incorporated; Philadelphia Stock

Exchange, Inc.; Spokane Stock Exchange.

On October 12, 1976, the Commission, pursuant to Section 19(a)(3) of the Exchange Act, issued an order withdrawing the registration of the Detroit Stock Exchange as a national securities exchange. That exchange had ceased operations at the close of business on June 30, 1976, in accordance with a plan of liquidation adopted by its governing committee on May 12, 1976, and approved by a majority of its membership on June 7, 1976.[2]

On October 13, 1977, the Honolulu Stock Exchange (HSE), the only securities exchange currently exempted from registration,[3] informed the Commission that it would cease operations as of December 30, 1977. At the end of the fiscal year, that exchange had begun taking the steps necessary to terminate its business operations in an orderly fashion and to seek termination of its exemption from registration as a national securities exchange.

Delisting

Pursuant to Section 12(d) of the Exchange Act, a security may be withdrawn from listing and registration with a national securities exchange upon the exchange's application to the Commission, or upon the application of its issuer, in accordance with the rules of the exchange and upon such terms as the Commission may impose for the protection of investors. In evaluating delisting applications, the Commission generally does not substitute its judgment for that of an exchange, and, where there has been full compliance with the rules of an exchange with respect to delisting, the Commission will grant a delisting application. The Commission's authority in such cases is limited to the imposition of terms deemed necessary for the protection of investors.[4]

The standards for delisting vary among the exchanges, but generally delisting actions are based on one or more of the following factors: (1) the number of publicly held shares or shareholders is insufficient (often as a result of acquisition or merger) to support a broad-based trading market; (2) the market value of the outstanding shares or the trading volume is inadequate; (3) the company no longer satisfies the exchange's listing criteria with respect to earnings or financial condition; or (4) required reports have not been filed with the exchange.

During the fiscal year, the Commission granted exchange applications for the delisting of 86 stock issues, 20 bond issues, and 5 warrants. Applications were granted to the individual exchanges as follows: American Stock Exchange (Amex), 35 stocks, 7 bonds and 5 warrants; Pacific Stock Exchange (PSE), 30 stocks and 1 bond; Philadelphia Stock Exchange (Phlx), 14 stocks and 1 bond; New York Stock Exchange (NYSE), 18 stocks and 12 bonds; Boston Stock Exchange (BSE), 1 stock; Midwest Stock Exchange (MSE), 6 stocks.[5]

The Commission also granted the application of 16 issuers to withdraw their securities from listing and registration on the Amex; 2 from the NYSE; 6 from the BSE; 1 from the Intermountain Stock Exchange; and 1 from the HSE.

Unlisted Trading Privileges

Prior to the 1975 Amendments, Section 12(f) of the Exchange Act provided that a national securities exchange might, upon application to and approval by the Commission, extend unlisted trading privileges to

any security listed and registered on another national securities exchange. The 1975 Amendments broadened that provision to encompass securities not listed on any other exchange; other textual changes reflected Congressional concern over the impact of unlisted trading on the development of a national market system and clarified that such applications may not be granted if the effect would be to restrict competition.[6]

On March 25, 1977, the PSE submitted an application for unlisted trading privileges in the common stock of Pacific Resources, Inc. The PSE application was the first application for unlisted trading privileges in a security not listed on another exchange filed pursuant to Section 12(f)(1)(C) for consideration by the Commission.[7]

At the end of fiscal year 1976,[8] the Commission had under review an Initial Decision[9] granting an application of the BSE for unlisted trading privileges in the common stock of Ludlow Corporation, which was already listed and registered on the NYSE.[10] On March 11, 1977, the Commission affirmed the decision of the Administrative Law Judge granting unlisted trading privileges.[11] The Commission held that the standards of Section 12(f) of the Exchange Act and Rule 12f-1 thereunder were met because considerable local interest existed in the security on the BSE, which provided an appropriate medium for trading the security. In addition, the Commission concluded that competitive factors existed which could lead to the execution of transactions on the BSE instead of the primary market, and there had not been any showing that the primary market would cease to be fair and orderly if unlisted trading privileges were extended to the BSE. The Commission stated that the "fair and orderly markets" standard, which was added to Section 12(f) by the 1975 Amendments, reflected congressional focus on the development of a national market system. On May 6, 1977, Ludlow filed a petition, which is currently pending, requesting the United States Court of Appeals for the District of Columbia Circuit to review and to set aside the Commission order granting the BSE application for unlisted trading privileges in Ludlow common stock.[12]

Exchange Disciplinary Actions

Section 19(d) of the Exchange Act requires exchanges to report for Commission review any final disciplinary sanction imposed by an exchange that (1) denies membership or participation to any applicant, (2) prohibits or limits access to services offered by an exchange or member thereof, or (3) imposes final disciplinary sanctions on any person associated with a member or bars any person from becoming associated with a member.

During the fiscal year, three exchanges reported to the Commission a total of 279 separate disciplinary actions. The sanctions imposed by the exchanges as a result of those actions included (1) the imposition of fines ranging from $350 to $75,000 in 177 cases, (2) the admonishment of 42 individuals, (3) the suspension from membership in the exchanges (for periods ranging from three weeks to three years) of three member organizations and 52 individuals, (4) the censure of four member firms and 75 individuals, (5) the barring from association with a member of 50 individuals and (6) the expulsion from membership of 28 individuals and two member firms.

EXCHANGE RULES

Section 19(b) of the Exchange Act,

as amended by the 1975 Amendments, requires self-regulatory organizations to file with the Commission any proposed rule or change in an existing rule accompanied by a concise statement of the basis and purpose.[13] Promptly after filing, the Commission is required to publish notice of the proposed rule change and to give interested parties an opportunity to submit their views on it. Proposed rule changes may not take effect unless approved by the Commission (with the exception of certain types of rule changes, such as interpretations of existing rules, which are permitted to take effect without Commission review, subject to the Commission's powers under Section 19(b)(3)(C) to abrogate such rule changes).

As previously reported,[14] the Commission has adopted Exchange Act Rule 19b–4 and related Forms 19b–4A and 19b–4B, which provide procedures by which self-regulatory organizations may file proposed rule changes for the Commission's approval or give notice of those rule changes which may take effect without Commission approval. The rule also provides the self-regulatory organizations criteria by which they may determine which of their policies, practices and interpretations are deemed to be rules for the purpose of the filing requirement. Furthermore, it specifies the procedures to be followed by the Commission in passing upon proposed rule changes.

During the fiscal year, the Commission received 248 submissions from exchanges involving a variety of rules and stated policies. The following were among the more significant rule changes considered by the Commission:

1. On June 15, 1976, the NYSE submitted a package of three rule proposals to remove major restrictions on floor trading activity, including a reduction in the minimum capital requirements applicable to registered floor traders. In connection with these proposals, the staff of the Division of Market Regulation conducted an inspection of the NYSE's capacity to conduct adequate regulation and surveillance of floor trading activities. On January 17, 1977, as a result of its inspection and analysis of the NYSE proposals, the Commission approved a reduction of the minimum capital requirement for registered floor traders from $250,000 to $25,000 and requested the NYSE to analyze further the remaining proposals in light of the Commission's comments thereon.

2. The Commission approved rule changes filed, respectively, by the Amex and the NYSE to rescind their so-called "New York City Rules," pursuant to which each exchange had prohibited trading on its floor of any security which was admitted to trading on any other exchange located in New York City. As a result of the Commission's approval of the these proposals, the common stock of Varo, Inc., became the first Amex-NYSE dual listing in more than fifty years. In addition, stock of six other companies is now dually traded on the Amex and the NYSE.

3. The Commission approved an NYSE rule change proposal to rescind certain restrictions with respect to "off-floor" trading by its members—that is, trades executed on the floor of the NYSE as a result of a member's order originating from off the floor. The restrictions generally prohibited an NYSE member who acquired stock by means of an off-floor order on a "plus" or "zero plus" tick, at or above the previous day's closing price, from selling that stock within twenty-four hours, except at a loss. These restrictions had been adopted in 1969 in

response to a Commission study which indicated that manipulation in a stock's price may result from concentrated and dominant trading by off-floor traders. The NYSE stated that the proposal was in response to improvements in communications facilities since the rule was adopted, and it agreed to implement a surveillance program to monitor its members' off-floor trading activities. The Commission's staff informed the NYSE that it would oversee the NYSE monitoring plan to ensure that the NYSE could effectively determine whether there had been a recurrence of the conduct which the rule was designed to prevent.

4. The Commission approved an NYSE rule proposal rescinding membership restrictions upon foreign broker-dealers and broker-dealers controlled by foreign parent organizations.

5. The Commission also approved rule changes filed by the NYSE requiring its listed companies to establish independent audit committees comprised solely of directors independent of management.[15]

6. The Commission disapproved a proposed Amex rule change which would have established alternate listing criteria for domestic corporations. In disapproving that proposed rule, the Commission noted that it would have expanded the universe of issuers whose stocks would be eligible for listing on the Amex and explained that, in light of Amex rules restricting off-board principal transactions in listed stocks, the Commission could not conclude that the Amex rule proposal was consistent with the requirements of the Exchange Act. At the end of the fiscal year, the Commission had under consideration an Amex request that the Commission reconsider its disapproval of this proposed rule change in conjunction with its consideration of a related Amex proposal concerning Amex foreign listing standards.

7. The Commission approved a proposed rule change filed by the Chicago Board Options Exchange, Incorporated (CBOE), enabling the CBOE to develop procedures for appointing its "board brokers" on the basis of a competitive bidding process.[16] The specific procedures were to be set forth in a subsequent filing by the CBOE and had not been received as the end of the fiscal year.

8. The Commission approved a rule change filed by the NYSE which eliminated the "three man" unit rule for specialist firms, rescinded a prohibition against the maintenance of joint limit orders by non-affiliated specialists in their specialist stocks, and lowered certain capital requirements for specialist firms.

9. The Commission approved an Amex rule proposal rescinding a prohibition against the entry of quotations of listed stocks by Amex members in over-the-counter quotation sheets and NASDAQ.

EXCHANGE INSPECTIONS

NYSE Advertising Inspection

On October 15, 1976, the NYSE filed proposed rule changes which would rescind its pre-clearance requirements for member advertising. The NYSE's pre-clearance of member advertising was viewed as a primary means of ensuring compliance with the NYSE's rules governing the content of member advertising.[17] In order to obtain information as to NYSE surveillance of member advertising under the existing rules and to evaluate the feasibility of proposed alternative procedures, members of the Commission's staff inspected (on December 9 and 10, 1976) the NYSE's Advertising and Sales Literature Review Section and, as a follow-up, inspected

(on January 10, 1977) the NYSE's Enforcement Department with respect to its enforcement of NYSE advertising standards.

On the basis of the information obtained during these inspections, and information submitted by the NYSE in support of its proposed rule change, the Commission was satisfied that rescission of the pre-clearance requirements for member advertising, and substitution of a post-use sampling review, probably would not lead to any substantial lessening of compliance with the NYSE advertising standards. Accordingly, the Commission approved the NYSE proposal.[18] In doing so, however, the Commission directed the staff to transmit a letter to the NYSE as to certain findings made during the course of the staff's inspections. In its letter, the staff communicated its concern that certain shortcomings in NYSE advertising review procedures be corrected to assure that the quality of member advertising not be allowed to deteriorate. The staff suggested that:

(1) An apparent lack of sufficient knowledge of the NYSE's substantive advertising standards should be corrected by the use of educational circulars and conferences between the NYSE staff and NYSE members;

(2) In order to ensure compliance with the NYSE's advertising standards, post-use sampling reviews may need to be conducted on a more frequent basis than once annually;

(3) Disciplinary actions should be pursued more vigorously by the NYSE staff as a means of enforcing the NYSE's advertising rules, particularly where repeat offenders are involved and warnings had been issued; and

(4) The NYSE should make greater efforts to avoid delay in investigating potential disciplinary cases.

NYSE Specialist Surveillance Inspection

From February 16–18, 1977, the Commission's staff conducted an inspection of the NYSE to review its programs for the regulation and surveillance of specialists and its recently revised procedures for the allocation of newly listed stocks. This was accomplished through interviews with NYSE staff personnel and examination of files pertaining to the interpretive and investigative activities of those individuals. Further, in the area of stock allocations, the Commission's staff examined procedures and standards for evaluating specialist performance and effecting stock allocations. In particular, the staff focused on the use of the Specialist Performance Evaluation Questionnaire (SPEQ), and grades derived therefrom, by the NYSE's Allocation Committee in effecting the assignment of newly-listed stocks.

By letter dated June 29, 1977, the findings of the Commission staff were communicated to the NYSE. The principal areas addressed in that letter were: (1) specialists' execution of percentage orders[19] and regulation thereof; (2) provision of an adequate audit trail to deter, among other things, the printing of fictitious trades (*i.e.*, reported transactions which appear on Network A of the Consolidated Tape but which are never cleared or settled); and (3) the relationship of stock allocation procedures to the potential for greater competition among specialists on the NYSE floor.

With respect to the first area, the NYSE undertook an educational program (partially in response to earlier Commission approval of an amended percentage order rule) to reinforce specialists' understanding as to the proper handling of percentage orders. In addition, the NYSE advised its

employees who conduct periodic inspections of specialists' trading records to effect certain procedures in order to monitor compliance in this area.

Concerning the question of an adequate audit trail, the NYSE has reported to the Commission's staff that it is continuing to explore alternative modifications in its transactional reporting system in order to incorporate certain features which the Commission deems essential for improved market surveillance. One such feature would be the ability to reconstruct, in a timely and accurate fashion, trading sequences in all NYSE-listed securities.

Finally, with regard to allocation procedures and standards, the Commission's staff observed that the NYSE's approach to this function presupposes the continued dominance of the unitary specialist system on the NYSE floor.[20] The NYSE recently submitted a proposed rule change which establishes minimum levels of acceptable specialist performance in terms of SPEQ grades. Failure to meet one or more of the minimum criteria for a specified period could result in the reallocation of one or more of the assigned stocks of the affected specialist. At the end of the fiscal year, the Commission had not completed its review of the procedures and standards which this proposal would establish.

Midwest Stock Exchange Inspection

On September 26–28, 1977, members of the Commission staff conducted an inspection of the MSE relating primarily to (1) the regulation and surveillance of stock specialists; (2) MSE procedures related to Regulation T extension requests by member firms; and (3) implementation of the MSE's program to allow members to function as registered market makers in stocks admitted to trading on the MSE.[21] In the course of this inspection, the Commission's staff conferred with several MSE employees and reviewed a variety of records pertaining to the operation of the MSE stock floor. In addition, the Commission's staff observed the transmission of orders to brokers on the MSE floor through the MSE's signet 80 and Quote 'n Trade systems as well as the execution and reporting of transactions on the floor.

In the area of specialist surveillance and regulation, members of the Commission's staff reviewed the MSE's procedures for ongoing surveillance of stock trading and implementation of a recently revised program for evaluating specialist performance. The latter is significant in that performance results will constitute the principal criteria for allocating newly listed stocks. The staff also examined the execution of odd-lot orders in NYSE-listed stocks which are admitted to trading on the MSE.

Another area upon which the inspection focused was the MSE's program in passing upon member requests for extensions of time within which customers must comply with Regulation T margin requirements. Concern in this area was heightened by the recent insolvency of an MSE member which had sought, and obtained, a number of Regulation T extensions in certain securities for which its customers subsequently refused to pay, contributing to the demise of the firm.[22]

The Commission's staff also observed the functioning of registered market makers on the MSE floor. The MSE's creation of this function was approved by the Commission in June 1977.[23] Members that register to act in this capacity serve as supplemental market makers in their respective assigned issues and thereby are able to accept market or limit orders in those issues. Where registered market makers accept orders in such issues,

their handling of those orders is generally governed by the same MSE rules which pertain to specialists acting under similar circumstances. The MSE believes that the registered market maker function will add greater depth and liquidity to the marketplace.

At the end of the fiscal year, the Commission's staff was continuing its review of the data and records obtained from the MSE. Upon completion of that review, a report discussing its findings will be transmitted to the MSE.

American Stock Exchange Options Program Inspection

On November 10–11, 1976, and on April 12–13, 1977, members of the Commission's staff conducted inspections of the Amex focusing primarily on (1) the adequacy of its member education programs in connection with its proposal to list put options for trading on its floor[24] and (2) the ability of the Amex's option surveillance systems to enable it adequately to enforce compliance with its rules and the Federal securities laws. Special attention was given to Amex procedures for monitoring member trading in securities underlying Amex-listed options, use by members of certain non-public information in effecting option transactions and member option transactions designed solely to produce benefits under option margin rules.[25] While the design of the Amex educational program appeared generally adequate to prepare members for the commencement of put trading on the exchange, the Commission's staff was concerned with the Amex's failure to make any substantial progress in developing surveillance procedures which would enable it to detect questionable member trading activity.

During that inspection, the Commission's staff was particularly concerned about the inability of the Amex to identify accurately those members executing particular option transactions,[26] and the staff suggested possible changes in Amex procedures which would correct this deficiency. By the April 1977 inspection, the Amex had instituted some new procedures designed to facilitate the collection of this information with respect to some option transactions, but as the fiscal year ended, substantial improvements still needed to be made.

Also, based in part on this inspection, it was determined that the Amex's surveillance programs were not adequate to determine whether its members or their customers were trading in concert with others in an attempt to evade rules of the exchanges on which options are traded (options exchanges) regarding maximum positions in an option class.[27] Subsequently, the Commission's staff found similar inadequacies in the surveillance programs of the other options exchanges. At the end of the fiscal year, the options exchanges had begun some efforts, working jointly with the Commission's staff, to develop ways of improving surveillance programs.[28]

Chicago Board Options Exchange Inspection

On April 4–5, 1977, the Commission's staff conducted an inspection of the CBOE which focused primarily upon the CBOE's procedures for enforcing member compliance with its rules concerning option selling practices and the trading of put options under the CBOE's proposed put option program. The inspection also included a review of the CBOE's system for monitoring the initial and continued

qualification of securities which underlie CBOE listed options.

Although the inspection team was concerned, in some cases, with delays in handling inquiries and complaints in the area of sales practices, the CBOE's complaint procedures in this area generally seemed satisfactory.[29] On the basis of that preliminary inquiry, the CBOE put option training program generally appeared adequate to apprise members of their responsibilities with regard to the trading of put options on the CBOE floor.[30]

In connection with its overall investigation and study of options trading,[31] the Commission contemplated the need for industry-wide standards for monitoring the performance of market makers on the floors of the options exchanges. In that regard, the Commission's inspection staff determined that the CBOE had made some limited progress toward defining and monitoring compliance with standards for the performance of market makers and other parties on the CBOE floor.[32]

Midwest Stock Exchange Options Program Inspection

On April 6, 1977, the Commission conducted its first inspection of the newly established pilot options program at the MSE.[33] The inspection focused upon the adequacy of the MSE's systems for the surveillance of options trading on its floor.

After reviewing the MSE's options market surveillance program, the Commission's inspection staff concluded that while it generally appeared to be adequate, at the then current trading volume, to monitor options trading by MSE members, it might well not be adequate to handle any substantial expansion in options trading on that exchange.[34] As the fiscal year ended, the MSE was responding to the Commission's suggestion that it improve its oversight capability by computerizing certain surveillance systems in anticipation of increased trading volume resulting from future expansions of the MSE's options pilot program.

The inspection indicated that the MSE was responding to suggestions by the Commission's staff that the MSE refine standards for evaluating market maker trading performance in order to justify the favorable margin treatment accorded to such options market participants.[35]

Following the commencement of its options pilot program, the MSE had upon occasion certified incorrectly that certain underlying securities for listed options met its requirements for initial and continued qualification,[36] and the Commission's staff had urged at that time that certain improvements be made by the MSE in its certification procedures. Based upon comments made by the MSE during the Commission's inspection, it appears that the MSE has now instituted certain new procedures to ascertain whether underlying securities meet its qualifications.

Pacific Stock Exchange Options Program Inspection

On April 7, 1977, the Commission's staff conducted an inspection of the PSE to determine whether its surveillance programs could accommodate an expanded options program.[37] The inspection also reviewed the adequacy of the PSE's educational programs for members and the operation of its disciplinary procedures for member violations of PSE rules.

Based upon the inspection, it appeared that the PSE's educational programs for put option trading,[38] and for the training of new floor members, generally were adequately designed to

inform members of their responsibilities under PSE rules, but that there were other deficiencies in the PSE's options program that require attention. Partially in response to suggestions of the Commission's staff during this inspection and another inspection conducted the preceding fiscal year,[39] the PSE modified and instituted a previously proposed system of fixed fines for relatively minor infractions of exchange rules. The object of the new system is to streamline the PSE's disciplinary process for minor infractions and to permit its enforcement staff to allocate more of its time and resources to other areas. The Commission's inspection team also noted a number of areas in which the PSE's surveillance systems, like those of other options exchanges, were demonstrably inadequate and had to be strengthened before existing options programs could be allowed to expand.[40]

Based, in part, on its staff's inspection of the options exchanges, the Commission subsequently determined that the surveillance and enforcement programs of each of the options exchanges appeared to be inadequate, and the staffs of the Commission and the options exchanges were working on solutions to the problem as the fiscal year ended.

SUPERVISION OF THE NASD

The Exchange Act provides that an association of brokers and dealers may be registered with the Commission as a national securities association if it meets the standards and requirements for the registration and operation of such associations contained in Section 15A of the Act. The Exchange Act contemplates that such associations will serve as a medium for self-regulation by over-the-counter brokers and dealers. In order to be eligible for registration, an association's rules must be designed to protect investors and the public interest, to promote just and equitable principles of trade and to meet other statutory requirements. Registered securities associations operate under the Commission's general supervisory authority, which includes the power to review disciplinary actions taken by an association, to approve or disapprove changes in the association's rules and to abrogate, add to and delete from such rules. The NASD is the only association registered with the Commission.

At the close of the fiscal year, 2,782 brokers and dealers were NASD members. This represented a net decrease of 113 members during the year, resulting from 207 admissions to and 320 terminations of membership. The number of members' branch offices increased by 226 to 6,194 as a result of the opening of 965 new offices and the closing of 739. During the fiscal year, the number of registered representatives and principals (which categories include all partners, officers, traders, salesmen and other persons employed by or affiliated with member firms in capacities which require registration) decreased by 2,103 to 192,396. This decrease reflects the net result of 15,635 initial registrations, 14,501 reregistrations and 32,239 terminations of registrations during the year.

In fiscal year 1977, the NASD administered 45,948 qualification examinations, of which 24,317 were for NASD qualification, 2,161 were for the Commission's SECO program[41] and the balance were for other agencies, including the major exchanges and various state securities regulators.

NASD Rules

Under Section 19(b) of the Exchange Act and Rule 19b–4 thereunder, the NASD is required to file with the Commission any proposed rule change,

accompanied by a concise general statement of its basis and purpose. The Commission is generally required to publish notice of the proposed rule change together with the terms of such change or a description of the subjects and issues involved and to give interested parties an opportunity to submit their views. Most proposed rule changes may not take effect unless approved by the Commission; however, certain rule changes, including those establishing or changing a due, fee, or other charge imposed by the NASD and those concerned solely with the administration of the NASD, need not be approved by the Commission before taking effect.

During the fiscal year, the NASD filed numerous rule changes with the Commission under Rule 19b–4. Among the major filings which the Commission approved were:

(1) Adoption of a new Section 33 to Article III of the NASD Rules of Fair Practice, which authorizes the Board of Governors of the NASD to adopt rules, regulations and procedures relating to transactions in options contracts, including options to be included in the NASDAQ System.[42] Under this new rule, the Board of Governors has the authority, among other things: (1) to develop a regulatory program consistent with existing standardized options trading plans and Commission rules and regulations governing options, and (2) to adopt rules governing trading in conventional over-the-counter option contracts as well as the activities of the NASD-only member firms doing business through option exchange members in exchange-listed options on an "access basis."[43]

(2) Amendments to Article XVII of the NASD By-Laws, Code of Arbitration Procedure and Uniform Practice Code, to reflect the transfer of the securities processing operations of the National Clearing Corporation (NCC), a wholly-owned subsidiary of the NASD, to the National Securities Clearing Corporation (NSCC).[44]

(3) Amendment to Section 1(a) of Schedule G under Article XVIII of the NASD By-Laws, to permit any member of the NASD to become a so-called "Designated Reporting Member" upon request, provided the member executes over-the-counter transactions in listed securities required to be reported on the Consolidated Tape and maintains transaction reporting capability through the NASDAQ Transaction Reporting System.[45]

NASD Inspections

During the past fiscal year, the Commission's staff conducted inspections of NASD district offices located in Atlanta, Boston, Chicago, Dallas, Denver, Kansas City, New Orleans, Seattle and Washington, D.C., and of the NASDAQ Qualifications Department in the NASD's Washington headquarters. These inspections were conducted as a part of the Commission's oversight responsibility to assure that the NASD is performing its self-regulatory functions adequately. They aid the Commission in determining whether there is a need for new rules, or for amendment or modification of existing Commission rules or NASD rules, policies or interpretations. They also are intended to further coordination of the Commission's and the NASD's regulatory and enforcement activities relating to the over-the-counter market.

The NASD district office inspections involved a review of (1) the composition and effectiveness of the District Business Conduct Committees, examination subcommittees, and nominating committees, (2) the functioning of the district staffs, especially their working relationships with the various commit-

tees composed of NASD-member firms, and (3) the district staffs' coordination and cooperation with the Commission's regional offices, the exchanges, and other interested regulatory bodies. Problems uncovered during these inspections related to (1) procedures for notifying the Commission's regional offices, either orally or in writing, of possible violations of Federal securities laws, (2) delays in the timely processing of disciplinary matters, (3) the thoroughness of certain investigations in response to customer complaints, and (4) adequacy of review of members' supervisory practices upon receipt of customer complaints or notices of termination of registered representatives' employment for cause. The staff also observed a need for (1) closer monitoring of district nominating committees to assure a fairer representation of their members on District Business Conduct Committees and (2) more complete member office examination reports and District Business Conduct Committee meeting minutes to include notation of all apparent violations and their disposition. All of these problems and observations were reviewed with representatives of the NASD's national office during the course of the fiscal year, and appropriate corrective action has been initiated or completed.

The purpose of the inspection of the NASD's NASDAQ Qualifications Department (Department) was to evaluate the effectiveness of the Department's enforcement of the NASDAQ qualification standards for an issuer's eligibility and continued inclusion in the NASDAQ system. The inspection revealed instances where the NASD had not (1) taken steps to remove promptly from the NASDAQ system securities of issuers which had not been filing required financial reports in a timely fashion and had not been maintaining the prescribed minimum $250,000 capital and surplus, (2) obtained current financial or other pertinent information with respect to foreign issuers included in the system in order to verify their compliance with applicable maintenance criteria, (3) routinely advised its market surveillance department of the names of delinquent issuers for which special monitoring efforts might be needed to detect any unusual trading problems relating to those issuers, or (4) scheduled hearings promptly in those instances where an issuer requested one after being notified that it was to be deleted from the NASDAQ system for not maintaining minimum qualification standards. The Commission's staff recommended to the NASD that, for the benefit of potential investors, the NASD should consider providing a means for identifying, on NASDAQ quotation display terminals, in newspapers and in various financial publications, issuers involved in Chapter X or XI bankruptcy proceedings. By the end of the fiscal year, the Department had initiated corrective procedures in most areas. The Commission's staff plans to conduct a follow-up review during the next fiscal year.

NASD Disciplinary Actions

The Commission receives from the NASD copies of its decisions in each case where disciplinary action is taken against a member or a person associated with a member. Generally, such actions are initiated on the basis of allegations that the respondents have violated specified provisions of the NASD Rules of Fair Practice. Where violations by a member firm are found, the NASD may impose such sanctions as expulsion, suspension, limitation of activities or operations, fine, censure, or other fitting sanction. If the violator is an individual, his regis-

tration with the NASD may be suspended, he may be barred from association with any member, or he may be fined, censured, or otherwise suitably sanctioned.

During the past fiscal year, the NASD reported to the Commission final disposition of 281 disciplinary complaints in which 156 members and 318 individuals were named as respondents. Complaints against 6 members and 26 individuals were dismissed for failure to establish the alleged violations. In its disciplinary actions, the NASD expelled 20 members from membership and suspended 5 members for periods ranging from one day to two years. The NASD imposed fines, ranging from $25 to $20,000, on members in 107 cases and censured members in 18 cases. In addition, the NASD barred 83 persons associated with member firms and suspended the registrations of 45 persons for periods ranging from one day to five years. Finally, the NASD imposed disciplinary sanctions on 164 other individuals in the form of censures or fines in amounts ranging from $100 to $20,000.

Review of NASD Disciplinary Actions

Section 19(d) of the Exchange Act requires a self-regulatory organization which imposes a disciplinary sanction on a member or a person associated with a member to file notice of such sanction with the Commission.[46] An action subject to the filing requirement may be reviewed by the Commission on its own motion or on the timely application of any person aggrieved by the action. The effectiveness of any sanction is not stayed pending appeal to the Commission unless the Commission so orders. If the Commission finds on review that the party against whom an action has been taken committed the acts found by the NASD, and that such acts violated the specified rules, the Commission must sustain the action unless it finds that the penalties imposed are excessive or oppressive. Such penalties may be reduced or set aside; the Commission may not, however, increase the penalties imposed by the NASD.

At the beginning of the fiscal year, 15 proceedings for review of NASD disciplinary actions were pending before the Commission, and during the year 13 additional cases were brought up for review. The Commission disposed of 13 of these appeals. In five cases, the Commission affirmed the NASD's action. The Commission set aside the NASD's action in one case, dismissed appeals in four cases because of the respondents' failure to file briefs, remanded two cases to the NASD, and permitted withdrawal of one appeal. At the close of the fiscal year, 15 appeals were pending.

Four significant opinions were issued during the fiscal year. In *Ben B. Reuben*,[47] the Commission affirmed the NASD's findings that the respondent violated the NASD Rules of Fair Practice by deliberately attempting to negotiate a check on behalf of a client when the respondent knew or should have known that the client was not entitled to the check. Respondent, a registered principal of an NASD member firm, caused the firm to issue a check to his client in payment for securities sold for the client's account. Several days later the firm put a stop payment order on the check and issued a duplicate check which was cashed by respondent and deposited in his personal account to be used for his client's benefit. Approximately one year later, after respondent had organized his own broker-dealer firm, the original check reappeared in his client's possession. The respondent, without consulting his own records or those of his previous firm, deposited

the check in his personal account, where it failed to clear. He explained that he suspected his client was not entitled to the check, but he nonetheless deposited it with the idea that clearance of the check would indicate that his client was in fact entitled to it. Respondent contended that the NASD had erred in finding his conduct inconsistent with just and equitable principles of trade, that he was denied due process, and that the sanctions imposed by the NASD—censure, a 30 day suspension and a $2,500 fine—were too harsh in view of the economic hardship he would suffer, the absence of prior history of misconduct on his part, and the fact that no one was injured as a result of his actions. The Commission affirmed the NASD's finding that Respondent's actions did not meet the standards imposed by the NASD's Rules of Fair Practice and found Respondent's due process arguments without substance. The Commission also affirmed the sanctions imposed, stating that, because disciplinary proceedings conducted by the securities industry's self-regulatory bodies under the "high standards of commercial honor and just and equitable principles of trade" standards are ethical in character, the fact that a violation of those standards did not result in actual harm does little, if anything, to mitigate the severity of the offense.

In *Hibbard & O'Connor Securities, Inc., et al.*,[48] the Commission affirmed findings of the NASD with respect to respondent's "parking" of securities to circumvent net capital requirements, failure to register salesmen, improper payments to an employee of another member of the NASD, and failure to comply with certain recordkeeping, customer protection and delivery requirements. Other findings against the member and an officer were set aside, and proceedings were remanded to the NASD for a reassessment of sanctions. The Commission noted, however, that the officer's attempt to cover up misconduct and to frustrate the NASD's investigation of alleged violations with respect to which he had not been named a party could be a basis for instituting new NASD proceedings against him.

With respect to the officer, the NASD District Committee had imposed a $2,000 fine and a censure for his alleged role in certain net capital hypothecation violations. After a hearing before the NASD Board of Governors, the fine was raised to $10,000 and the officer was barred from association with any NASD member because the Board found that the officer had attempted to cover up misconduct concerning improper payments to another member's employee and to inhibit the NASD's investigation of the improper payments. On review the Commission set aside the NASD's findings of violations in which the officer allegedly participated; accordingly, no findings adverse to the officer could be predicated on them. Moreover, the Commission found that since the officer had never been charged with participation in the improper payments or with attempting to obstruct the NASD's investigation, the alleged obstruction could not serve as a basis for adverse findings against the officer. The Commission noted, however, that its reversal of the NASD's actions with respect to the officer did not preclude the institution of new NASD proceedings against him based upon his alleged efforts to cover up the improper payments and to frustrate the NASD's investigation.

In *Waldron & Co., Inc.*,[49] the Commission, in reviewing a disciplinary action by the NASD, rejected the member's claim that it was deprived of a

fair and impartial hearing, sustained the NASD's finding that the member and its president had sold securities at unfair prices and affirmed the sanctions imposed. The NASD found that the member and its president had executed, on a principal basis, a series of securities sales to members of the public at prices not reasonably related to the then current market prices, thereby violating the NASD's "mark-up" policy.[50] The member argued to the Commission that the proper base on which to compute the mark-up was not the firm's contemporaneous cost, but rather the primary market maker's asked price in the sheets published by the National Quotation Bureau, Inc. The Commission rejected this argument, noting that the member (as well as other broker-dealers) had purchased the security in question from the primary market maker at prices less than the asked price quoted in the "pink sheets." On that basis, the Commission found that the best evidence of the prevailing market price was the member's contemporaneous cost.

In *Fred K. Kerpen*,[51] the Commission affirmed action taken by the NASD against a member and its registered principal, where the principal failed to take timely steps to discover conversion of customers' funds by a registered representative of the member and to prevent future occurrences of such incidents. On appeal to the Commission, while not disputing the NASD's findings with respect to the misconduct of the registered representative, the member and principal expressed disagreement concerning the steps that should have been taken by the principal to discover and prevent the misconduct. The principal argued that he had failed to take action against the registered representative following an initial complaint involving forgery and conversion because the allegations, when made, appeared incredible in view of the representative's previous good reputation in the investment community. Nevertheless, following subsequent complaints from other customers, the principal continued to fail to examine the representative's accounts or to terminate his employment, apparently choosing to attempt to rehabilitate the representative. The NASD found, and the Commission affirmed, that the principal was negligent in failing to supervise, particularly following the subsequent complaints against the representative. It was further argued that the sanction imposed by the NASD against the principal—a ten-day suspension—was excessive, particularly since the principal devoted only part of his time to the firm, which no longer had any full-time employees. The Commission affirmed the sanction, noting that one of the purposes of the disciplinary action is to indicate to other members the seriousness with which the NASD regards failure to supervise employees.[52]

Review of NASD Membership Action

Under Section 15A(g)(2) of the Exchange Act, the NASD must notify the Commission of its intention to admit to membership a registered broker-dealer subject to a statutory disqualification, or to permit a statutorily disqualified person to become associated with a member, not less than 30 days before the member's admission or the person's association. At the time the notice is filed, the NASD may apply for an order stating that, notwithstanding the disqualification, the Commission will not proceed under those provisions of the Exchange Act empowering the Commission to exclude the firm or associated person. The Commission, in its discretion and subject to such terms and conditions as it deems

necessary, may issue an order permitting such membership or association if it finds such action appropriate in the public interest and for the protection of investors. At the beginning of the fiscal year, four applications of this nature were pending before the Commission. During the year, four applications were filed, four were approved and three were withdrawn, leaving one application pending at the end of the year.

SUPERVISION OF THE MUNICIPAL SECURITIES RULEMAKING BOARD

The Municipal Securities Rulemaking Board (the MSRB) was established under the 1975 Amendments as a self-regulatory organization whose principal purpose is to draft and submit for Commission approval[53] a comprehensive body of rules establishing standards for the municipal securities industry. During the fiscal year, the MSRB filed with the Commission over 40 proposed rule changes and amendments to proposed rule changes. The following were among the more significant rule changes approved by the Commission:

(1) The Commission approved a series of MSRB rules concerning professional qualifications of members of the municipal securities industry.[54] Basically, the rules provide for examination of prospective industry members and require each of those persons who have not previously been employed in the securities industry to serve a 90-day apprenticeship before transacting a municipal securities business with the public. In addition, the rules provide for the examination of supervisory personnel, including persons responsible for the financial affairs of securities firms engaged in the municipal securities business. The rules also require the collection of pertinent information concerning the background of all personnel engaged in underwriting, trading and sales of municipal securities.

(2) The Commission also approved a series of MSRB recordkeeping rules designed to assure that securities firms and banks maintain certain basic information concerning their activities as municipal market professionals, both for purposes of their own operations and to permit the conduct of compliance examinations by the regulatory agencies.

(3) The MSRB adopted, and the Commission approved, a customer confirmation rule which requires municipal securities dealers to provide their customers with pertinent information concerning their transactions in municipal securities including several items of information necessary to describe accurately the securities[55] purchased.

(4) The Commission also approved the MSRB's rule G-12 which establishes uniform industry practices relating to the processing, clearance and settlement of transactions in municipal securities. Rule G-12 is intended, among other things, to increase the efficiency and reduce disputes concerning the delivery of securities.[56] The provisions of rule G-12 are applicable only to transactions between municipal securities professionals and do not apply to municipal securities transactions with customers.

REVENUES, EXPENSES AND OPERATIONS OF SELF-REGULATORY ORGANIZATIONS

Section 23(b)(4)(B) of the Exchange Act requires that the Commission submit "a statement and analysis of the expenses and operations of each self-regulatory organization in connection with the performance of its responsibilities under this title." As set forth in Section 3(a)(26) of the Exchange Act, the term "self-regulatory organi-

zation" refers to any national securities exchange, registered securities association (*i.e.*, the NASD), registered clearing agency, and, for limited purposes, the MSRB.

Self-regulatory organizations, exclusive of registered clearing agencies and the MSRB, receive approximately 75 percent of their revenue from five sources: transaction charges, listing fees, communication fees, clearing fees and depository fees. The nature of these revenue sources makes the financial condition of self-regulatory organizations highly dependent upon price fluctuations and trading volume.

Total share volume of securities traded on all national securities exchanges and over-the-counter increased by 14.5 percent between calendar year 1975 and 1976, bringing 1976 share volume to 8.7 billion. As a result of this increased trading activity, combined self-regulatory organization revenues increased to $249 million, up $44 million from the 1975 total.

Changes in major revenue components between 1975 and 1976 were as follows:

- Revenues from transaction fees increased to $39 million from $33 million;
- Revenues from communication fees increased to $39 million from $26 million;
- Revenues from clearing fees increased to $41 million from $35 million;
- Revenues from tabulating services increased to $17 million from $14 million; and
- Revenues from all "other" sources increased to $43 million from $38 million.

The expenses of the self-regulatory organizations are concentrated in two areas, employee costs and communication and data processing costs. These costs accounted for 74 percent of the $233 million in self-regulatory expenditures for 1976.

In 1976, for the second consecutive year, the net income of self-regulatory organizations, exclusive of the registered clearing agencies and the MSRB, increased. The 1976 pre-tax income of self-regulatory oganizations equaled $17 million, a $3 million increase over 1975's earnings.

Financial Results of the NASD

Each year the Commission reviews the NASD's proposed fee and assessment schedule, its supporting financial statements for the current and past fiscal years, and proposed budget for the following fiscal year. The fee and assessment schedule must comply with Section 15A(b)(5) of the Exchange Act, which requires the NASD to allocate dues equitably among its members.

The NASD's statement of financial results for its fiscal year ended September 30, 1976 revealed that the NASD's equity increased to $11.1 million from $9.2 million in the prior year. This increase in the NASD's equity resulted principally from higher net operating earnings and to a lesser extent from profitable operations of NASDAQ, Inc.

Operating revenues of the NASD were $22.2 million, an increase of $9.2 million over the previous year's operating revenues. This increase resulted primarily in $8.0 million in new revenues from the newly acquired NASDAQ system. Other sources of income generally remained stable. Fees charged for administering qualifications examinations appears to have stabilized, at $2.4 million in 1976. Member assessments and branch office fees increased from $5.9 million in fiscal year 1975 to $6.5 million in 1976, a 10 percent increase.

During the 1976 fiscal year, operating expenses of the NASD increased to $20.5 million from $12.0 million in fiscal year 1975, thus, net operating income for fiscal 1976 was $1.8 million as opposed to $0.9 million in the prior year, a marked increase. In addition, in fiscal year 1976, the National Clearing Corporation had net income of $0.2 million which, when added to the NASD's net income, increased the NASD equity by $2.0 million, as compared with a net increase of $1.4 million in its 1975 fiscal year.

NASD Budget

The Commission reviews the NASD budget as part of its regulatory oversight responsibilities. During recent years, the Commission has been specifically interested in the NASD's budget as it relates to its program for examination of member broker-dealers, in order to assure that the NASD has a sufficient examiner staff to perform its enforcement and surveillance responsibilities. The NASD budget for fiscal year 1977 provides for total expenditures of $13.67 million in fiscal year 1977, an increase of $1.7 million. The increase is largely attributable to the increase in employee compensation which increased by $1.05 million to $10.35 million.

The NASD has projected its income for fiscal year 1978 at $15.42 million, based upon its current schedule of fees and assessments. The NASD fee structure remains unchanged for fiscal year 1978, but the annual assessment base has been modified. The fiscal year 1977 gross income assessment rate was 0.2 percent of a member's revenues from municipal securities transactions and 0.25 percent of a member's revenue from other over-the-counter securities transactions during calendar year 1975. The fiscal year 1978 rates would be 0.17 percent and 0.21 percent, respectively, of revenue derived from municipal securities and over-the-counter transactions during calendar year 1976.

American Stock Exchange, Midwest Stock Exchange, National Association of Securities Dealers, and New York Stock Exchange

In calendar year 1976, the markets governed by the four largest self-regulatory organizations (in terms of total revenue) — the Amex, the MSE, the NASD, and the NYSE — experienced rising share volume. On the NYSE, share volume rose from 5.1 billion in 1975 to 5.6 billion in 1976, an increase of 12 percent. For the same period, MSE share volume increased 7 percent, share volume from over-the-counter transactions by members of the NASD increased 21 percent, and AMEX share volume increased 18 percent. This rise in share volume resulted in increased revenues for those four self-regulatory organizations.

The Amex experienced the second largest share volume increase of the four self-regulatory organizations and, with the growth in options trading, the largest percentage increase in revenues. In 1976 total revenue increased 37 percent from 1975. Transaction fees accounted for much of the increase with a 62 percent gain from 1975 to 1976. This increase in revenues, coupled with a 33 percent increase in expenses, resulted in an increase of net income of 258 percent to $1.5 million.

The MSE posted a 21 percent increase in revenue between 1975 and 1976 with the largest gains occurring in depository and registration fees. Although the MSE's revenue increased 21 percent in 1976, expenses increased even more, by 23 percent, and as a result net income declined by 24 percent to $745,000.

The NYSE ranked third among the four largest self-regulatory organizations in percentage gain in total revenue between 1975 and 1976. Even with the rise in NYSE share volume, transaction fees decreased $314,000. Listing fees increased 37 percent from $23 million in 1975 to $31 million in 1976. Depository fees and floor usage revenue also increased $5 million. Much of the revenue improvement was carried through to pre-tax income, which increased $1.6 million from 1975 to 1976.

NASD revenues are not as sensitive to changes in volume as are those of the national securities exchanges. As a result, the NASD had the smallest percentage increase in total revenue of the four largest self-regulatory organizations between 1975 and 1976, approximately 12 percent. The NASD's expenses for the same period increased, however, by only ten percent; and, consequently, the NASD had a net income of $2 million in 1976, compared to a net income of $1.3 million in 1975.

Boston Stock Exchange, Chicago Board Options Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange

The next four largest self-regulatory organizations (in terms of gross revenue) also experienced rising revenues, expenses and volume. During 1976, share volume on the BSE increased by 3 percent; the CBOE experienced a 49 percent increase in contract volume; the PSE gained 38 percent in volume; and the Phlx gained 3 percent in share volume.

The CBOE's increase in volume generated a 120 percent rise in membership dues and a 63 percent increase in communication fees. Expenses for the CBOE, however, increased 51 percent during 1976. The items with largest gains were depreciation and amortization (141 percent increase) and communications, data processing and collection (121 percent increase). Earnings in 1976 were 4 percent higher than in 1975.

The BSE's rise in revenue came from two sources: increased transactions fees and the opening of the New England Securities Depository Trust Company in 1976. Share volume increased from 54 million in 1975 to 56 million in 1976. Expenses increased 30 percent from January to December, 1976. This resulted in a decline in net income to $150,000, a decrease of 58 percent from 1975.

The PSE also experienced increases in revenue due to greater volume. Nevertheless, the PSE had large increases in its expenses, particularly communications, data processing and collection and professional and legal services, which caused net income to fall again this year. Expenses exceeded revenues by $686,000 in 1976.

Phlx also registered gains in total revenue. Between 1975 and 1976 Phlx gained 21 percent in total revenue, primarily because of a 93 percent increase in transaction fees. Pretax income increased to $230,000 in 1976 representing a 174 percent increase over 1975.

Cincinnati Stock Exchange, Spokane Stock Exchange, and Intermountain Stock Exchange

Following the trend of the four largest self-regulatory organizations, the Cincinnati Stock Exchange (CSE) and the Spokane Stock Exchange (SSE) also experienced rising share volume in 1976.

In 1976 the CSE nearly tripled its portion of total share volume; this was the second year of continued increases in share volume. Total revenue, however, decreased 35 percent with

the largest changes occurring in transaction fees, membership dues, and floor usage revenue. Expenses increased 10 percent in 1976, causing pre-tax income to decline from $35 thousand in 1975 to a loss of $18 thousand in 1976.

The SSE, which receives income primarily from membership dues and listing fees, had offsetting increases in total revenue and total expenses for 1976.

Most of the Intermountain Stock Exchange (ISE) revenue is from miscellaneous sources. While revenue rose in 1976, expenses rose more, reducing pre-tax income for the year.

Expenses and Operations of Registered Clearing Agencies

Clearing agencies were required by the 1975 Amendments to register with the Commission by December 1, 1975. This is the first year that operating revenues and expenses for registered clearing agencies have been presented in the Commission's annual report separately from revenue and expense data for the exchanges or securities association with which many of the clearing agencies are affiliated.[57] Accordingly, a comparative analysis of this data cannot be made against prior years' operations. As reported in the statistics section of this report at Table 10, Self-Regulatory Organizations– Clearing Agencies,[58] total revenues for all clearing agencies were $93.1 million for their fiscal years ending in 1976 (except OCC, for which figures are included for a fiscal year ending June 30, 1977). Revenues from clearing services were $50.6 million; from depository services, $34.8 million; and from interest and other sources, $7.7 million.

Since the operating results of many clearing agencies historically have been presented as part of the consolidated operating reports of securities exchanges and the NASD, the statistics section of this report at Table 8, Consolidated Revenues and Expenses of Self-Regulatory Organizations, also presents revenues from clearing fees and depository fees for affiliated clearing agencies. These consolidated reports show that, for calendar year 1976, revenues from clearing fees increased by 16 percent over calendar year 1975 to $41.2 million and revenues from depository fees increased 30 percent over calendar year 1975 to $36.2 million.[59]

While 1976 trading volume increased only 13.6 percent over 1975 volume, clearing and depository fee revenues for clearing agency subsidiaries of self-regulatory organizations increased by much larger percentages. The increase in revenues may not entirely be accounted for by increases in fees charged; it appears, therefore, that there is an increasing use of clearing agencies by the securities industry, which will further reduce the physical movement of securities certificates.

Municipal Securities Rulemaking Board

The MSRB income of $420,994 during the transitional quarter from July 1, 1976 to September 30, 1976 and $1,338,115 during fiscal year 1977 (as reported in the Part 9 of this report at Table 11, Self-Regulatory Organization–Municipal Securities Rulemaking Board) was derived primarily from two fees established by rules adopted under the Securities Act. Municipal securities brokers and municipal securities dealers are assessed (1) an initial registration fee of one hundred dollars and (2) an underwriting assessment equal to a percentage of the face value of all municipal securities they purchase from an issuer as part of a new is-

sue which has a final stated maturity of not less than two years from the date of the securities.[60] The underwriting assessment accounted for 99 percent of MSRB income during the transitional quarter and 94 percent of MSRB income during fiscal year 1977. The balance of MSRB income was from other fees and interest income.

During the fiscal year, the MSRB had expenses which totaled $957,088. The major expense items were staff salary and benefits (43 percent); meetings and travel including Board members' allowance of $250 per day (27 percent); and mailing lists, rule manuals, postage and other printing (14 percent). During the transitional quarter, income exceeded expenses by $227, 486; and, during fiscal year 1977, despite the reduction in the underwriting assessment, income exceeded expenses by $574,535. As of September 30, 1977, the MSRB had a surplus of $1,084,413.

BROKER-DEALER REGULATION

Persons Deemed Not to be Brokers

Section 15(a) of the Exchange Act generally requires, with certain exceptions, the registration of any broker or dealer which uses the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security. Section 3(a)(4) of the Exchange Act, in turn, provides that the term 'broker' means "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." The Commission's staff frequently has been requested to interpret the applicability of the broker-dealer registration requirement of the Exchange Act to those situations in which an issuer of securities elects not to employ a registered broker-dealer in the distribution of its securities, but instead utilizes the services of its officers, directors, or other employees to effect a distribution. Such a method of distribution is frequently employed by, among others, promoters of tax-sheltered interests such as real estate syndications or oil and gas drilling programs. In this regard, the Exchange Act generally has not been interpreted by the staff to require the registration of the issuer itself as a broker or dealer.[61] At the same time, however, persons acting on behalf of the issuer in distributing its securities may, depending on the circumstances, be brokers (or, more infrequently, dealers) within the meaning of the Exchange Act.

On January 21, 1977, the Commission published for comment proposed Exchange Act Rule 3a4–1,[62] which is designed to clarify the circumstances under which persons distributing securities on behalf of an issuer are deemed not to be "brokers" within the meaning of Section 3(a)(4). If adopted in the form proposed, Rule 3a4–1 would establish a "safe harbor" within which natural persons associated with an issuer would not be deemed to be brokers. Generally, an associated person of an issuer might avail himself of this "safe harbor" in one of three ways: (1) by confining his participation to certain kinds of transactions, such as offers and sales made through a registered broker-dealer or to certain institutions, (2) by being a *bona fide* employee meeting specified criteria set forth in the proposed rule with regard to frequency of involvement in selling securities, performance of other duties with the issuer and nature of compensation, or (3) by restricting his activities in connection with a distribution to ministerial or other essentially passive func-

tions. The "safe harbor" of proposed Rule 3a4-1 would not be available, however, to any person subject to a "statutory disqualification" within the meaning of Section 3(a)(39) of the Exchange Act.

Exemption from Registration for Certain Financial Institutions

On November 11, 1976, the Commission adopted Exchange Act Rule 15a-5 which provides an exemption from the Act's broker-dealer registration requirement for non-bank lenders participating in the guaranteed loan program of the Small Business Administration (SBA).[63] The securities activities of such lenders must be limited to making loans guaranteed by the SBA and selling the guaranteed portion of such loans. The rule, however, permits such a financial institution participating in the SBA loan program to sell the guaranteed portion of a note evidencing such indebtedness provided that the sale is made through or to a broker or dealer registered with the Commission or to a bank, a savings institution, an insurance company, or an account over which an investment adviser registered under the Investment Advisers Act of 1940 exercises investment discretion.

Rule 15a-5 is intended to facilitate participation by qualified lending institutions in the SBA's guaranteed loan program by exempting such institutions from regulatory requirements under the Exchange Act which, under the circumstances, are not necessary for the protection of investors. Under its loan program, the SBA has sought to encourage private financing of small business concerns by providing a guarantee of a portion of an approved loan to an eligible small business enterprise. In order to increase the supply of capital available to such businesses, the SBA also has encouraged the development of a secondary market in the guaranteed portion of such loans. Rule 15a-5 represents an effort by the Commission to reduce duplicative regulation which might frustrate the goals of the SBA's loan program.

Financial Responsibility Requirements

The 1975 Amendments required the Commission to establish, not later than September 1, 1975, minimum standards of financial responsibility for brokers and dealers. On June 26, 1975, fulfilling this congressional directive, the Commission amended Exchange Act Rule 15c3-1 to adopt a uniform net capital rule.[64] During the fiscal year, the Commission further amended the uniform net capital rule to refine its requirements based on the year's experience and to respond to specific regulatory concerns, particularly relating to the treatment of options positions.

On November 20, 1975, the Commission implemented a series of temporary amendments to Rule 15c3-1 to provide a transitional period for municipal securities brokers and municipal securities dealers newly subject to the financial responsibility standards of Section 15(c) of the Exchange Act.[65] Most significantly, the rule reduced, on an interim basis, the capital required by brokers and dealers effecting transactions solely in municipal securities in order to qualify for the alternative net capital requirement.[66] After carefully monitoring the effect of this temporary amendment for approximately a year and a half, the Commission determined that the $25,000 minimum capital requirement was appropriate and, on July 28, 1977, permanently adopted the temporary amendment.[67]

Under the net capital rule, effective January 1, 1977, brokers and dealers

were permitted to reduce substantially the "haircuts"[68] on short-term commercial paper rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations. On December 30, 1976, at the request of certain major dealers in commercial paper, the Commission solicited public comment on possible alternatives to requiring ratings by two rating services.[69] After reviewing the proposals submitted in response, the Commission, on June 16, 1977,[70] reaffirmed the two-rating requirement as a prerequisite for the reduced haircuts.

On May 23, 1977, the Commission adopted modifications to the uniform net capital rule and the customer protection rule in order to prohibit brokers and dealers from effecting substantial short sales of securities without sufficient capital to carry such transactions.[71] The amendment applies to brokers or dealers which maintain short security positions for extended periods of time in stock loan or broker-dealer accounts receivable and requires that they obtain sufficient collateral to secure such receivables fully or, in lieu of such collateral, reduce their net worth and establish reserves to the extent of such collateral deficiencies.

On September 2, 1977, the Commission further amended the net capital rule in order to adjust the treatment accorded positions in options.[72] These amendments (1) revised the provisions relating to the capital requirements for brokers and dealers which carry, clear, endorse, or guarantee (carrying firms) the accounts of options specialists or market makers, (2) established early warning notification requirements for such carrying firms, and (3) limited, on the basis of their net capital, the market maker positions such firms can carry. In order to assure that the capital position of a carrying firm reflects the risk attributable to the positions in each of its market maker accounts assessed on an account-by-account basis, the Commission amended the rule to require the consolidation of securities positions held in multiple market maker accounts carried by a firm. The early warning provisions require that a carrying firm promptly notify the Commission and the designated examining authority if at any time a market maker fails to make certain deposits or if the aggregate deductions attributable to all market maker accounts carried by the clearing firm exceed 1,000 percent of the carrying firm's net capital. In addition to the notification requirements, the amendments prohibit a carrying broker from allowing these deductions to exceed 1,000 percent of the carrying broker's net capital for a period exceeding five business days.

The Commission also amended the net capital rule in order to establish a financial responsibility standard for options specialists and market makers which transact a business solely with other brokers and dealers who, because of the nature of their business (*i.e.*, traders on the floor of an exchange[73] or clearing members of a clearing corporation[74]), are not exempt from the requirements of the net capital rule.

Recordkeeping and Preservation Requirements

Exchange Act Rules 17a–3 and 17a–4 require registered brokers and dealers to make, keep current, and preserve for specified periods certain books and records relating to their business. During the past fiscal year the Commission adopted four major amendments to these rules in order to adjust the requirements in accordance

with developments in the securities industry.

On February 24, 1977, the Commission approved the MSRB's recordkeeping and record-retention rules for municipal securities brokers and municipal dealers, rules G-8 and G-9.[75] Because the MSRB's rules establish standards substantially similar to those prescribed by Exchange Act Rules 17a-3 and 17a-4, the Commission amended its recordkeeping and preservation rules in order to permit municipal securities brokers and municipal securities dealers to elect to comply with either the generic requirements of the Commission's rules or the more specific requirements of MSRB rules G-8 and G-9.

The Commission also adopted paragraph (a) (14) of Rule 17a-3 and paragraph (e) (4) of Rule 17a-4 in order to incorporate recordkeeping and retention requirements relating to the Lost and Stolen Securities Program.[76] Under the amended rules, every member, broker or dealer must make, and retain in an easily accessible place for a period of three years reports concerning lost, missing, stolen, and counterfeit securities,[77] and all confirmations of inquiry or other information received from the Federal Reserve Banks or the Securities Information Center, Inc., the Commission's designee under the Lost and Stolen Securities Program.[78]

On April 22, 1977, the Commission amended Exchange Act Rule 17a-4 (b) (9) to require brokers or dealers subject to Rule 15c3-3 to maintain a current and detailed description of the procedures they utilize to comply with Rule 15c3-3.[79] This recordkeeping requirement is consistent with the revised FOCUS report which is discussed below.

Finally, on September 15, 1977, the Commission adopted a new paragraph (i) to Exchange Act Rule 17a-4.[80] This paragraph provides that any outside service bureau, depository, bank not operating pursuant to Exchange Act Rule 17a-3(b) (2), or other recordkeeping service which prepares or maintains a broker's or dealer's books and records must acknowledge that such books and records are the property of the broker-dealer and must represent, among other things, that such books and records are available for examination by the Commission and its designees. Such Commission designees include a trustee appointed pursuant to the Securities Investors Protection Act of 1970 (SIPC Act)[81] and the self-regulatory organization designated to inspect the broker or dealer for compliance with financial responsibility rules pursuant to the SIPC Act and Exchange Act Rule 17d-1.

FOCUS Reporting System

The Financial and Operational Combined Uniform Single (FOCUS) reporting system, Form X-17A-5, which became effective on January 1, 1976,[82] superseded the previously existing and often uncoordinated reporting systems used by the Commission, the self-regulatory organizations and the state securities agencies in their surveillance registration programs. The FOCUS report[83] is designed to present, clearly and concisely, data reflecting the financial status and operational condition of a firm. The report has generally eliminated the necessity for a broker-dealer to prepare and file multiple reports with more than one regulator.

During the fiscal year, the Commission adopted a number of amendments to the reporting program on the basis of a continuing reevaluation of the needs of the self-regulatory organi-

zations, the Commission and the 45 states which use the system.[84] In particular, Forms X-17A-10 and X-17A-20 were revoked, and that information previously submitted on these forms was incorporated into Form X-17A-5. The Commission also revised the reporting requirements on Form X-17A-5. A broker or dealer subject to amended Exchange Act Rule 15c3-3 must represent that its procedures for obtaining possession or control of customers' funds and securities have been tested and are functioning in a manner adequate to fulfill the requirements of Rule 15c3-3. In addition, a broker or dealer is required to report the number and market value of securities not in its possession or control as of the report date. In order to facilitate an independent assessment of the adequacy of a broker's or dealer's procedures, the Commission also proposed[85] that Form X-17A-5 include data on the number and market value of a customer's fully paid and excess margin securities for which the instructions required by Exchange Act Rule 15 c3-3 had not been issued as of the report date.

In addition, the Commission amended the reporting program to require an independent public accountant, as part of the annual audit, to review a broker-dealer's procedures for obtaining and maintaining possession or control of certain customer securities pursuant to Exchange Act Rule 15c3-3, and to give its opinion as to the adequacy of those procedures. On June 30, 1977, however, the Commission suspended this requirement until January 1, 1978, in order to evaluate whether Rule 15c3-3 constituted a sufficient standard of adequacy and to consider alternatives to that requirement.[86] At the close of the fiscal year, the Commission was in the process of analyzing the comments received.

Broker-Dealer Examinations

The Commission, as part of its review of compliance by brokers and dealers with the provisions of the Exchange Act, the rules under that Act, and the rules of the self-regulatory organizations of which such brokers and dealers are members, conducts an examination program for SECO brokers and dealers, self-regulatory organizations and members of self-regulatory organizations.

The Commission conducts two types of examinations of SECO brokers and dealers. The first, a routine examination, is conducted on an annual basis to determine the financial and operational condition of the firm. A second type of examination, the "cause" examination, is conducted whenever a financial or operational problem is discovered or suspected, and generally concentrates on that particular problem area rather than the overall condition of the firm. During the fiscal year, the Commission conducted 232 routine examinations and 91 cause examinations of SECO firms.

In addition, under Section 15(b) (2) (C) of the Exchange Act, as amended by the 1975 Amendments, the Commission, or a self-regulatory organization acting at the Commission's direction, is required to examine each newly registered broker or dealer within six months of its registration. Accordingly, the Commission conducts examinations of each SECO registrant under its Post Effective Conference Program. During the fiscal year, the Commission conducted 277 such examinations. In addition, the Commission has directed each self-regulatory organization to conduct a similar examination of any newly-registered broker or dealer for which it is the

designated examining authority under Exchange Act Rule 17d-1.

The Commission also reviews the programs and procedures implemented by self-regulatory organizations to fulfill their regulatory responsibilities under Sections 6, 15A, and 19(g)(1) of the Exchange Act.[87] One phase of this review, consisting of on-site inspections of a self-regulatory organization's examination and compliance programs and facilities, is the primary responsibility of the Commission's Division of Market Regulation. The second phase—the "oversight" examination—is the primary responsibility of the Commission's regional offices. This examination is designed to evaluate the adequacy and quality of the examinations performed by the self-regulatory organizations.

In the "oversight" examination, conducted promptly after the completion of a self-regulatory organization's examination, the Commission reviews the financial and operational condition of a member broker or dealer.[88] Generally, the specific findings of the examination are discussed with the self-regulatory organization shortly after the examination, and the working papers, reports and evaluations prepared by the self-regulatory organization as part of its examination of the broker or dealer are compared to the information gathered and the conclusions formed by the Commission's staff. During the transition quarter and the fiscal year, the Commission conducted 427 oversight examinations.

The Commission also conducts, as necessary, cause examinations of member firms. These examinations are nearly identical in purpose and scope to the Commission's cause examination of SECO brokers and dealers. During the fiscal year, the Commission conducted 467 cause examinations of member firms.

The Commission continues to update its Broker-Dealer Examination Manual and Checklist to reflect the current rules and regulations applicable to brokers and dealers.[89] In addition, the Commission prepares and distributes to all its regional offices educational materials on new regulatory developments and examination techniques to supplement the Broker-Dealer Examination Manual to inform the securities compliance examiners of such matters. The Commission's staff also prepares and transmits to the regional offices a monthly status report regarding new rule proposals and regulatory developments, the Commission's examination program and the surveillance and examination efforts of the self-regulatory organizations.

Early Warning and Surveillance

The Commission is responsible for the financial and operational soundness of all registered brokers and dealers. In this connection, pursuant to Section 5(a) of the SIPC Act, the Commission requires each self-regulatory organization to identify member firms which may be in or approaching financial difficulty or which, for other reasons, may require closer-than-normal surveillance. Each firm so identified is placed on an "early warning" list, which is transmitted on a bi-weekly basis to the appropriate Commission regional office. While on the early warning list, a firm is monitored by the Commission's regional office, acting in conjunction with the firm's self-regulatory examining authority.

In addition, Exchange Act Rule 17a-11 requires a broker or dealer to notify the Commission and the appropriate self-regulatory organization if the firm falls below certain standards of financial and operational soundness, measured in terms of capi-

tal sufficiency and adequacy of books and records. A firm not in compliance with the rule must take immediate remedial action and provide the Commission with financial and operational information on an accelerated basis.

The Commission, in a two-phased program, periodically reviews the early warning and surveillance tools of the self-regulatory organizations to ensure that they constitute sound, effective programs. In the first phase, the Commission's staff evaluates the self-regulatory organization's early warning and surveillance program, including its goals, procedures, budget and staffing. In that connection, the Commission maintains on-going communication with all self-regulatory organizations, particularly those which have not been inspected during the past fiscal year, to determine the status of their regulatory programs.

The second phase of the Commission's early warning and surveillance program, generally carried out by its regional offices, involves an on-site review of member firms to determine their understanding of and compliance with the applicable early warning standards and procedures. As a rule, a regional office combines its evaluation with a review of the firm's financial and operational soundness and of the self-regulatory organization's most recent examination of that firm.

The Commission's efforts, in conjunction with those of the self-regulatory organizations, to develop comprehensive and effective early warning and surveillance programs explain, in part, the steady decline in the number of securities firms which have been subject to liquidation in the past several years.[90] Seven liquidation proceedings under the SIPC Act were commenced during the fiscal year.

Training Program

The Commission administers comprehensive periodic training programs for securities compliance examiners, both those on the Commission's staff and those employed by the self-regulatory organizations.[91] These programs are designed to broaden the knowledge and the skills of the examiners and acquaint them with the latest modifications of examination procedures.

The Commission's training efforts essentially consist of four distinct programs:

(1) Periodic two-day training seminars conducted at each regional office and dealing with the Commission's oversight examinations. Such seminars review the results of oversight examinations, discuss any new and important developments or techniques emerging from these examinations, and provide an opportunity for the regional offices to discuss with self-regulatory organization staff members means to refine and to coordinate more closely their examination programs and techniques.

(2) Two-day seminars held twice each year in each regional office for the more experienced securities compliance examiners on the subject of examination techniques. Such seminars discuss significant new developments in the industry and particular examination techniques that may be used to deal with such developments.

(3) One four-day training seminar held at the Commission's headquarters. This seminar provides examiners from the Commission, the self-regulatory organizations and State securities commissions with information on basic examination techniques, as well as the various regulatory programs of the Commission pertaining to broker-dealer financial and operational compliance.

(4) Bi-weekly, one-hour training sessions in the regional offices for the Commission's examiners. These sessions focus on new developments, regulatory problems, rules and examination techniques.

In addition, the individuals charged with primary responsibility for each regional office's examination program meet every three months with the Commission's staff to discuss new training and examination techniques, areas where additional training is required, and the strengths and weaknesses of the Commission's current regulatory program. Such meetings ensure uniformity of regulation throughout the Commission's regional offices and contribute to the continuing refinement of the Commission's training and examination programs.

Regulatory Burdens on Brokers and Dealers

In recent years the Commission has become increasingly cognizant of the need to evaluate carefully the impact, on both competitive and regulatory levels, of the substantive requirements of its rules and regulations on brokers and dealers, especially the smaller firms. As a consequence, the Commission has undertaken a number of programs aimed at streamlining and simplifying requirements for the securities industry.

As noted above, on July 28, 1977, the Commission amended the net capital requirement, Exchange Act Rule 15c3–1,[92] to permit brokers and dealers transacting business solely in municipal securities, generally smaller brokers and dealers, to operate under the alternative net capital requirement while maintaining only the greater of $25,000 or four percent of aggregate debit items in the reserve formula rather than the $100,000 minimum required of other brokers and dealers.[93]

The Commission's program to allocate regulatory responsibilities under Rule 17d–2, in conjunction with the development of uniform registration (Form BD), agent application (Form U–4), and agent termination (Form U–5) forms,[94] has been a catalyst for reducing regulatory burdens among brokers and dealers. Under the Commission's program, a number of self-regulatory organizations have reached agreements to share key summary financial and operational information among themselves and with state administrators. These agreements help obviate the necessity for brokers and dealers to file multiple copies of information with numerous regulators and thus reduce the burden (and the cost) of regulation.

In implementing Lost and Stolen Securities Program, the Commission provided exemptions from the inquiry requirements of Rule 17f–1 where it is unlikely that missing, lost, counterfeit, or stolen securities would be involved.[95] In instances where inquiry is required, the Commission has approved, on a pilot basis, a system under which institutions may tailor their participation according to their business needs. It is expected, therefore, that smaller firms which do not anticipate making any required inquiries or can obtain lower charges through a correspondent may choose to become indirect inquirers.

Similarly, in adopting Rule 17f–2,[96] which implements the congressional directive that securities industry personnel be fingerprinted, the Commission attempted to reduce the burden of compliance on brokers and dealers while still offering maximum protection to the investing public. In order to ease implementation of the rule, which requires the fingerprinting of

all persons who are engaged in the sale of securities, who have access to securities or monies or original books and records relating thereto, or who supervise persons engaged in such activities, the Commission provided for the rule to become effective on a gradual basis.[97]

Finally, the Commission revised the alternative net capital requirement for any broker acting solely as a floor broker on a national securities exchange. As adopted in 1975, the net capital rule required floor brokers to maintain net capital of at least $25,000 predicated on the fact that the value of an exchange membership generally exceeded that amount. In recognition of the current market value of such memberships, on May 23, 1977, the Commission made this provision available where the membership value exceeded $15,000 or where the excess of $15,000 over the value of the membership was held in escrow by an independent agent.[98]

Regulation of SECO broker-dealers

Under Section 15(b) of the Exchange Act, the Commission is responsible for prescribing rules establishing qualifications standards for all brokers and dealers, including those who are not members of the NASD (nonmember or SECO brokers or dealers). This section also empowers the Commission to adopt rules governing the business conduct of SECO brokers and dealers, in order to provide regulation of such brokers and dealers comparable to that provided by the NASD for its members.

At the close of the fiscal year, the number of SECO brokers and dealers registered with the Commission and not entitled to an exemption from the Commission's SECO rules totaled 309, and the number of associated persons of such firms (i.e., partners, officers, directors, sole proprietors and employees not engaged in merely clerical or ministerial functions) totaled 23,236.

Exchange Act Rule 15b9-2 imposes an annual assessment to be paid by SECO brokers and dealers to defray the cost of their regulation by the Commission. On September 9, 1977, the Commission announced the adoption of the annual assessment form for SECO brokers and dealers for fiscal 1977 (Form SECO-4-77).[99] In adopting Form SECO-4-77, the Commission modified the assessment by reducing the gross income assessment from 0.375 percent to 0.2 percent for municipal securities transactions and 0.25 percent for OTC securities transactions.[100] The annual base SECO firm and personnel assessment ($250 and $5, respectively) remained unchanged.

CLEARANCE AND SETTLEMENT

Progress Toward a National System for the Clearance and Settlement of Securities Transactions

With the Commission's active encouragement, entities involved in securities processing improved during the fiscal year their ability to complete securities transactions in a prompt, accurate and economical manner. The continued development of interfaces among clearing corporations and depositories (which immobilize securities certificates and allow participants to complete transactions and move securities throughout the country by book entry) tended to reduce costs and accelerate the settlement process.

Recently adopted Exchange Act Rules 17Ad-1 through -7 are designed to protect investors and to facilitate the establishment of a national system for the clearance and settlement of securities transactions by

assuring that the transfer agent community performs its functions in a prompt, accurate and more predictable manner, and, by prohibiting those transfer agents which are unable to do so, from expanding their transfer agent activities.[101]

As a result of such improvements, as well as the increased participation in depositories by broker-dealers, banks and other institutions, the Commission believes that substantial progress is being made toward the development of an efficient national system for the clearance and settlement of securities transactions. The Commission expects that the continued development and refinement of clearing and depository services will attract more persons to become participants in these systems because of the substantial benefits which accrue from such participation. The increased number of participants will, in turn, contribute toward the effectiveness of the national system by enabling greater numbers of securities transactions to be cleared and settled through book-entry movement.

Rule Changes of Registered Clearing Agencies

Numerous changes in, or additions to, the rules, practices and operations of the twelve registered clearing agencies[102] were submitted to the Commission for its approval under the provisions of Section 19(b) of the Exchange Act and Rule 19b–4 thereunder. The following are among the most significant items on which the Commission acted favorably:

(1) The Options Clearing Corporation (OCC) amended its rules to permit each clearing member of OCC to effect settlements in respect of exercised option contracts through a clearing agency designated by the clearing member for that purpose. Previously, a clearing member of OCC was required to effect settlement of exercised option contracts through an account sponsored by OCC at one clearing agency. Now, a clearing member of OCC is permitted to exercise and settle options transactions through its regular clearing account maintained directly with a clearing agency of its choice. This allows the designated clearing agency to net the exercised option transactions against other securities transactions of the clearing member.[103]

(2) OCC also amended its rules to permit put option contracts and to provide for the clearance and settlement of put transactions and exercises.[104] Other changes in OCC's rules were adopted to permit option contracts to be exercised on the same date the option contracts were purchased[105] and to provide for the automatic exercise of certain "in-the-money" option contracts held in a clearing member's account on the expiration date of such option contracts.[106]

(3) Stock Clearing Corporation of Philadelphia (SCCP) adopted amendments permitting members to use its depository facility to hypothecate securities to a bank by means of a book entry pledge.[107]

(4) SCCP also implemented a continuous net settlement system as an alternative to trade-for-trade clearance.[108] That system was established in order to permit members with high volume to net transactions in specific issues, thereby reducing the cost of securities processing.

(5) The Depository Trust Company (DTC) and the Pacific Securities Depository Trust Company (PSDTC) each adopted rule changes providing for an interface between the two entities.[109] The depository-to-depository interface

permits book entry movements of securities between DTC and PSDTC.

(6) The National Securities Clearing Corporation (NSCC) adopted[110] amendments to the rules of its Stock Clearing Corporation (SCC) Division and its American Stock Exchange Clearing Corporation (ASECC) Division providing for the settlement of Amex transactions in listed debt securities through NSCC's SCC Division rather than through NSCC's ASECC Division. The amendments were designed to permit the inclusion of all Amex-listed debt securities transactions in the SCC Division's interfaces with Midwest Clearing Corporation (MCC), Pacific Clearing Corporation, and SCCP. NSCC also adopted[111] a rule change of the SCC Division of NSCC expanding the class of persons who may become Special Representatives to include any registered clearing agency and any member of the SCC Division of NSCC. This rule change permits a non-member of the SCC Division to have trades compared by NSCC but cleared and settled by regional clearing agencies and allows parties to compare a trade outside NSCC and then submit the trade to NSCC for clearance and settlement via the Special Representative. Bradford National Clearing Corporation and Bradford Securities Processing Services, Inc. (BSPS), filed a petition in the United States Court of Appeals for the District of Columbia Circuit seeking to reverse the approval of these rules.[112]

(7) MCC and Midwest Securities Trust Company (MSTC) adopted rule changes providing for a pledge loan program.[113] The program enables participants, via book entry, to pledge with banks, as collateral for loans, their securities held in the depository.

(8) MSTC and DTC each adopted rule changes to provide a book entry settlement capability for securities transactions between participants of the two depositories even though one or both participants might not be a participant in both depositories.[114]

(9) The New England Securities Depository Trust Company adopted a number of rule changes providing for the establishment of interfaces with DTC[115] and MSTC.[116]

(10) Pacific Securities Depository Trust Company adopted rules providing for the implementation of a Transfer Agent Custodian program.[117] As part of that program, PSDTC, through agreements with transfer agents, will maintain at the transfer agent shares it holds on deposit.

(11) TAD Depository Corporation (TAD) adopted a change in its rules to provide for the establishment of an interface with DTC.[118]

(12) TAD also amended its rules to establish a collateral loan service for its participants.[119]

(13) BSPS adopted several rule changes providing for the establishment of regional clearing centers through which its participants may submit securities transactions for settlement.[120]

SECURITIES INVESTOR PROTECTION CORPORATION

The SIPC Act established the Securities Investor Protection Corporation (SIPC) to provide certain protections to customers of member brokers and dealers who were unable to meet their financial obligations to their customers. SIPC is a non-profit membership corporation, and all registered brokers and dealers and all members of national securities exchanges are, with certain limited exceptions, members.[121] SIPC is funded primarily through assessments on its members, although it may borrow up to $1 billion from

the U.S. Treasury under certain conditions.

Liquidation Proceedings

During the period covered by fiscal year 1977, liquidation proceedings under the SIPC Act were initiated for seven SIPC members. While most of the cases involved claims by a relatively small number of customers, SIPC advanced over a million dollars to the trustee of Institutional Securities of Colorado, Inc., and over $900,000 to the trustee of A.H. Speer Co. Total claims will also be quite substantial in the liquidation of Swift, Henke & Co., Inc., and I.E.S. Management Group, Inc.

Litigation Related to SIPC

The membership in SIPC of a registered broker-dealer who marketed the shares of mutual funds and advised the funds as well as its clients was at issue in *Massachusetts Financial Services, Inc. v. SIPC*.[122] The broker-dealer asserted that, as a broker-dealer registered to engage exclusively in the marketing of shares of mutual funds, it was exempt from SIPC membership pursuant to the exception in Section 3(a) (2) of the SIPC Act[123] and was not liable for assessments. The firm also performed other functions, none of which required broker-dealer registration, that went beyond the statutory exceptions. SIPC argued that once the firm registered as a broker-dealer, it became a SIPC member by virtue of its other activities that are not among the specific exceptions and thus could be assessed for the non-exempt activities. The Court of Appeals for the First Circuit disagreed and affirmed the decision of the District Court that the broker-dealer was not a SIPC member because all of its activity as a broker-dealer was statutorily exempted.

In *SIPC v. Executive Securities Corporation*,[124] a broker-dealer and an educational institution had lent securities to the broker-dealer in exchange for full cash collateral. When the latter firm became insolvent, the lenders sought to recover losses by claiming customer status under the SIPC Act. The Court of Appeals for the Second Circuit, affirming the orders of the bankruptcy court and the District Court below, held that the broker-dealer and the institution maintained neither investment nor trading accounts with the debtor and, therefore, were not within the class of investors or traders entitled to protection as "customers" under the SIPC Act.

In *Stock Clearing Corporation v. Weis Securities*,[125] SCC, a subsidiary of the NYSE, sought to reclaim securities which it had delivered to the debtor in exchange for an uncertified check on the debtor's bank account which had been frozen upon initiation of the debtor's liquidation. SIPC instituted the proceeding a few hours after the securities were delivered. Shortly thereafter, SCC, having been informed that the account was frozen, accepted the check, which later was returned for insufficient funds to SCC. SCC argued that the securities had been delivered to the debtor on the condition that they would be paid for in cash and that the debtor's failure to fulfill the condition precluded the securities from passing into the debtor's estate. The Court of Appeals for the Second Circuit, affirming the lower court decision, held that since SCC had knowingly accepted an uncertified check on a frozen bank account it had effectively relied on the debtor's credit since there was reason to believe the check could not be converted into cash immediately. Accordingly, the

court held, SCC could not reclaim the securities.

By-Law Proposals Submitted by SIPC to the Commission

In July 1977, SIPC submitted a proposed by-law change to repeal Section 5 of Article 3 of the SIPC by-laws, which required the Board of Directors to meet at least once each quarter.[126] The proposal was approved by the Commission on August 31, 1977.

EXEMPTIONS

The Commission granted various exemptions from provisions of the Exchange Act during the fiscal year. On November 11, 1976, the Commission adopted Rule 15a-5, which provides an exemption from the Act's broker-dealer registration requirement for non-bank lenders participating in the guaranteed loan program of the Small Business Administration.[127]

Exchange Act Rule 10b–6 imposes certain prohibitions upon trading in securities by persons interested in a distribution of such securities. During the fiscal year, the Commission granted approximately 300 exemptions under paragraph (f) of Rule 10b–6 under circumstances indicating that the transactions did not appear to constitute manipulative or deceptive devices or contrivances within the meaning of the Exchange Act.

One application pursuant to Section 15B(a) (4) for exemption from the municipal securities dealer registration requirements and the rules and regulations applicable to municipal securities dealers was received by the Commission and granted as consistent with the public interest, the protection of investors, and the purposes of Section 15B.

Other applications for exemption from the provision of the Exchange Act are discussed elsewhere in this Annual Report, in connection with the individual provisions pertinent to those applications.

NOTES TO PART 3

[1]Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97.

[2]42nd Annual Report at 77–78.

[3]Section 5 of the Exchange Act requires exchanges to register with the Commission as national securities exchanges or to seek an exemption from such registration. Exemptions may be granted in cases where the volume of transactions effected on the exchange is limited.

[4]*See Ecological Science Corp.*, Securities Exchange Act Release No. 10217 (June 13, 1973), 1 SEC Docket 5, and cases cited therein. *See also Clary Corp.*, Securities Exchange Act Release No. 11751 (October 20, 1975), 8 SEC Docket 196; *BBI, Inc.*, Securities Exchange Act Release No. 11686 (September 26, 1975), 7 SEC Docket 978. There were not any contested delistings during fiscal year 1977.

[5]In addition, an application by the Amex to strike the stock of University Savings Association was granted by the Federal Home Loan Bank Board, pursuant to its authority under Section 12(i) of the Exchange Act.

[6]*See* S. Rep. No. 75, 94th Cong., 1st Sess. 106 (1975); H. Conf. Rep. No. 229, 94th Cong., 1st Sess. 95 (1975).

[7]*See* Part 1, *supra* at p. 15 for a discussion of PSE's application for unlisted trading privileges. On February 7, 1977, the Phlx submitted an application for unlisted trading in four securities not listed on any exchange: American Greetings Corporation, Combined Insurance Company of America, Kearney and Trecker Corporation and Pennzoil Off-Shore Gas Operators. That application, however, was subsequently withdrawn by the Phlx.

[8]42nd Annual Report at 78–79.

[9]BSE, Administrative Proceeding File No. 3-4646 (May 6, 1976).

[10]Application for Unlisted Trading Privileges in Common Stock of Ludlow Corp. by the BSE, File No. 7–4596 (filed April 23, 1974).

[11]Securities Exchange Act Release No. 13359 (March 11, 1977).

[12]Petition for Review, United States Court of Appeals for the District of Columbia Docket No. 77–1417, filed May 4, 1977.

[13]This requirement applies to the rules of exchanges as well as rules of the National Association of Securities Dealers, Inc. (NASD), clearing agencies and the MSRB.

[14]42nd Annual Report at 79.

[15]Part 1, *supra* at p. 27.

[16]On December 13, 1977, a group of board brokers on the CBOE filed a notice of appeal in the United States Court of Appeals for the Seventh Circuit challenging

the Commission's approval order (Carey et al v. SEC, No. 77–1704). The litigation was pending as of the end of the year.

[17]The proposed rule changes did not involve any changes in the substantive standards governing member advertising.

[18]Securities Exchange Act Release No. 13238 (February 2, 1977), 11 SEC Docket 1633.

[19]The Commission's concern over the handling of percentage orders arose from inspections that indicated that the NYSE did not have adequate procedures, including recordkeeping, to prevent specialists from handling percentage orders on a discretionary basis in violation of Section 11(b) of the Act.

[20]The staff noted that, since SPEQ grades are the primary allocation criteria, it would be difficult for a new specialist unit, although possessing adequate capital and qualified personnel, to compete with established units for the allocation of stocks which become listed on the NYSE.

[21]The scope of this inspection did not extend to the MSE options program.

[22]Litigation Release No. 7843 (March 23, 1977), 11 SEC Docket 2146.

[23]Securities Exchange Act Release No. 13651 (June 20, 1977), 12 SEC Docket 925.

[24]The Amex commenced put option trading under a strictly limited and carefully controlled pilot program on June 3, 1977. Securities Exchange Act Release No. 13592 (June 2, 1977), 12 SEC Docket 692.

[25]By executing a transaction at the close of business which moves the price of an option up or down, a member could alter his daily margin requirement for his positions in that option.

[26]This lack of an "audit trail" resulted because, under procedures then in effect, Amex personnel reported the terms of trades without requiring written indicia thereof from the parties to the trade.

[27]Each Options Exchange has established uniform maximum limits on the size of positions in a particular option class which may be held by a member or member's customer, acting either alone or in concert with others. *See, e.g.*, Amex Rule 904.

[28]*See* Part 1, *supra* at p. 14, concerning the imposition of a moratorium on the expansion of options programs.

[29]The Commission has, however, been concerned that the CBOE and other options exchanges have apparently not organized any comprehensive enforcement efforts to develop and pursue cases in this area. At the end of the fiscal year, this subject was being considered in connection with the Commission's review and investigation of the standardized options markets. *See* discussion, *supra* at p. 15.

[30]The CBOE commenced put option trading under a strictly limited and carefully controlled pilot program on June 3, 1977. Securities Exchange Act Release No. 13587 (June 2, 1977), 12 SEC Docket 690.

[31]As discussed in Part 1, *supra* at p. 15, the Commission has instituted an investigation and study of standardized options trading. Securities Exchange Act Release No. 14056 (October 7, 1977), 13 SEC Docket 356.

[32]For example, since the Commission's last inspection, the CBOE had developed a minimum attendance standard for market makers and had instituted a program whereby it now receives comments upon the performance of each market participant (including market makers, floor brokers and board brokers) from other CBOE floor members who have daily contact with them.

[33]As discussed at p. 13, *supra*, the MSE began listing standardized call options on December 10, 1976. Securities Exchange Act Release No. 13045 (December 8, 1976), 11 SEC Docket 1120.

[34]As the fiscal year ended, the Commission was, however, studying a number of problems related to surveillance of options markets which were not limited to any one exchange. *See* discussion in Part 1, *supra* at p. 15.

[35]Article XLVII, Rule 6, of the MSE rules provides that markets makers' option transactions on the MSE should constitute a course of business reasonably calculated to contribute to the maintenance of a fair and orderly market. In order to monitor and enforce compliance with this rule, the MSE was developing minimum attendance standards for market makers, guidelines concerning percentages of trades which they may execute in certain option classes, and procedures to obtain input from other floor participants concerning market maker performance.

[36]These requirements are set forth in Article XLI, Rules 3 and 4, of the MSE rules.

[37]At the time of the inspection, the Commission had pending before it a rule proposal by the PSE to expand from 30 to 50 the maximum number of stocks on which call options could be listed. The PSE subsequently filed another rule proposal to extend this maximum number to 80 classes. In connection with its investigation and study of standardized trading (discussed in Part 1, *supra* at p. 15), the Commission commenced disapproval proceedings with respect to these proposals. Securities Exchange Act Release No. 14057 (October 17, 1977), 13 SEC Docket 375.

[38]The PSE commenced put option trading under a strictly limited and carefully controlled pilot program on June 3, 1977. Securities Exchange Act Release No. 13589 (June 2, 1977), 12 SEC Docket 691.

[39]42nd Annual Report at 17–18.

[40]One such area involved the use by exchange members who are members of The Options Clearing Corporation (OCC) of the OCC Adjusted Trade Report. This report is used by clearing members to make changes in their accounts with OCC to permit correction of errors after the final clearing process is completed. However, because review of this report was not incorporated into the exchange surveillance programs, the Commission has become concerned that clearing members might employ this report to abuse the trade adjustment process. As the fiscal year ended, the Commission was evaluating this problem in connection with its investigation and study of standardized options markets. *See* discussion in Part 1, *supra* at p. 15.

[41]Those registered broker-dealers which are not NASD members are referred to as SECO broker-dealers (the term "SECO" being an acronym standing for SEC Only).

[42]Securities Exchange Act Release No. 13162 (January 13, 1977), 11 SEC Docket 1448.

[43]*See* the sections entitled "Regulation of the Options Markets" and "Options Morotorium" in Part 1, *supra* at p. 12–15, for a discussion of subsequent developments in this area.

[44]This proposed rule change became effective concurrent with the Commission's order granting registration to the NSCC and the NSCC's implementation of the terms, conditions and directives contained in that order. Securities Exchange Act Release No. 13163 (January 13, 1977), 7 SEC Docket 1448.

[45]Securities Exchange Act Release No. 13860 (August 15, 1977), 12 SEC Docket 1526.

[46]Securities Exchange Act Rules 19d–1, 19d–2, 19d–3 and 19h–1 set forth the form and content for such notices. *See* Part 1, *supra* at p. 21.

[47]Securities Exchange Act Release No. 12944 (November 2, 1976), 10 SEC Docket 847.

[48]Securities Exchange Act Release No. 13996 (September 27, 1977), 13 SEC Docket 231.

[49]Securities Exchange Act Release No. 12872 (October 6, 1976), 10 SEC Docket 663.

[50]NASD Mark-up Policy Interpretation, Article III, Section 4, NASD Manual (CCH) para. 2154 (April 21, 1977).

[51]Securities Exchange Act Release No. 12898 (October 15, 1976), 10 SEC Docket 722.

[52]*Petition for review denied*, *F. K. Kerpen & Co., v. SEC*, 559 F.2d 1203 (2d Cir. 1977).

[53]Under Section 19(b) of the Exchange Act and Rule 19b–4 thereunder, self-regulatory organizations are required to file with the Commission any proposed rule change and a concise general statement of the basis and purpose of such proposed rule change. The Commission must then publish notice of the proposed rule change together with either the terms of such change or a description of the subjects and issues involved and must give parties an opportunity to submit their views. Most proposed rule changes may not take effect unless approved by the Commission; however, certain rule changes, including those establishing or changing fees, dues or other charges, imposed by a self-regulatory organization or rules concerned soley with the administration of the self-regulatory organization, may become effective without Commission review, subject to the power of the Commission under Section 19(b)(3)(C) to abrogate such rule changes.

[54]Securities Exchange Act Release No. 12949 (November 3, 1976), 10 SEC Docket 850; Securities Exchange Act Release No. 13274 (February 16, 1977), 11 SEC Docket 1747; Securities Exchange Act Release No. 13905 (August 31, 1977), 12 SEC Docket 1636; Securities Exchange Act Release No. 14038 (October 7, 1977), 13 SEC Docket 307.

[55]Securities Exchange Act Release No. 13942 (September 9, 1977), 13 SEC Docket 60.

[56]Securities Exchange Act Release No. 13939 (September 8, 1977), 13 SEC Docket 26.

[57]42nd Annual Report at 98.

[58]Separate revenue and expense figures are included in Table 10 for American Stock Exchange Clearing Corporation (ASECC), National Clearing Corporation (NCC), Stock Clearing Corporation (SCC). In January 1977, the Commission granted registration to the NSCC an entity formed to combine the operations conducted by ASECC, NCC and SCC. On September 24, 1976, the Commission granted registration to the New England Securities Depository Trust Company (NESDTC). *See* p. 22, *supra*. The Commission expects to conclude the NSCC and NESDTC revenue and expense figures in its Annual Report for fiscal year 1978.

[59]The difference in the reported revenue figures for clearing and depository services and fees in Table 8 and 10, result from the following factors: (1) clearing agencies which are not affiliated with other self-regulatory organizations are not included in Table 8; (2) the periods covered in Table 8 are on a calendar year basis while the periods in Table 10 are on the clearing agencies fiscal year basis; and (3) the reporting entities may not use the same classifications in reporting revenue items.

[60]That fee amounted to 0.005 percent for all sales prior to November 1, 1976; 0.003 percent for all sales from November 1,

1976 through June 30, 1977; and 0.002 percent for all sales from July 1, 1977 through October 31, 1977. Effective November 1, 1977, the fee was reduced to 0.001 percent.

[61]As a general matter, the issuer would not be deemed to be in the business of effecting transactions in securities for the account of others as a broker, or buying and selling securities for its own account as a dealer. Section 3(a)(5) of the Exchange Act defines the term "dealer" to mean "any person engaged in the business of buying and selling securities for its own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business."

[62]Securities Exchange Act Release No. 13195 (January 21, 1977), 11 SEC Docket 1552.

[63]Securities Exchange Act Release No. 12967 (November 11, 1976), 10 SEC Docket 904.

[64]Securities Exchange Act Release No. 11497 (June 26, 1975), 7 SEC Docket 241.

[65]Securities Exchange Act Release No. 11854 (November 20, 1975), 8 SEC Docket 459. While many of these temporary amendments expired, the Commission extended until March 1, 1978, a number of amendments relating to certain receivables and undue concentrations in municipal securities. Securities Exchange Act Release No. 12482 (May 26, 1976), 9 SEC Docket 722; Securities Exchange Act Release No. 13113 (December 28, 1976), 11 SEC Docket 1322; Securities Exchange Act Release No. 13488 (April 29, 1977), 12 SEC Docket 285; and Securities Exchange Act Release No. 13806 (July 28, 1977), 12 SEC Docket 1381.

[66]As amended, Exchange Act Rule 15c3–1(f)(1)(a) permits brokers and dealers effecting transactions solely in municipal securities to operate under the alternative method while maintaining net capital at least equal to the greater of $25,000 (rather than $100,000 as required of other brokers and dealers) or 4 percent of aggregate debit items computed under a reserve formula, 17 CFR 240.15c3–3a (1976). Smaller municipal securities firms would have experienced substantial difficulty in maintaining the $100,000 of net capital otherwise required by Rule 15c3–1(f)(1)(a).

[67]Securities Exchange Act Release No. 13806 (July 28, 1977), 12 SEC Docket 1381.

[68]In determining the value of its assets for purposes of computing its net capital, a broker or dealer must reduce the value of securities held for its own account by prescribed amounts (commonly known as "haircuts"), which are calibrated on the basis of the volatility and marketability of the securities.

[69]Securities Exchange Act Release No. 13125 (December 20, 1976), 11 SEC Docket 1353.

[70]Securities Exchange Act Release No. 13635 (June 16, 1977), 12 SEC Docket 850.

[71]Securities Exchange Act Release No. 13565 (May 23, 1977), 12 SEC Docket 463.

[72]Securities Exchange Act Release No. 12766 (September 2, 1976), 10 SEC Docket 362.

[73]Securities Exchange Act Release No. 12766 (September 2, 1976), 10 SEC Docket 362.

[74]Securities Exchange Act Release No. 13623 (June 13, 1977), 12 SEC Docket 823.

[75]Securities Exchange Act Release No. 13296 (February 24, 1977), 11 SEC Docket 1833.

[76]Securities Exchange Act Release No. 13831 (August 5, 1977), 12 SEC Docket 1456.

[77]Securities Exchange Act Release No. 13280 (February 18, 1977), 11 SEC Docket 1804.

[78]See Part 1, *supra* at p. 29.

[79]Securities Exchange Act Release No. 13462 (April 22, 1977), 12 SEC Docket 156.

[80]Securities Exchange Act Release No. 13962 (September 15, 1977), 13 SEC Docket 71.

[81]15 U.S.C. 78aaa (1970).

[82]Securities Exchange Act Release No. 11935 (December 17, 1975), 8 SEC Docket 808. 42nd Annual Report at 12–14.

[83]The FOCUS reporting system serves multiple purposes, including surveillance of a broker's or dealer's financial and operational condition, annual review of its activity, transmission of relevant data to customers, and collection of economic and statistical information. It consists of the following parts: (1) a monthly filing by brokers and dealers which carry or clear customers' accounts (Part I); (2) quarterly filing by brokers and dealers which carry or clear customer accounts (Part II), and by brokers and dealers which introduce their accounts on a fully disclosed basis to another broker or dealer (Part IIA, an abbreviated version of Part II); and (3) an audited annual report (Part III). 42nd Annual Report at 12–14.

[84]Securities Exchange Act Release No. 13462 (April 22, 1977), 12 SEC Docket 156.

[85]Securities Exchange Act Release No. 13461 (April 22, 1977), 12 SEC Docket 86. Part II would otherwise require that this information be submitted on a quarterly basis.

[86]Securities Exchange Act Release No.

13713 (July 1, 1977), 12 SEC Docket 1108.

[87]Securities Exchange Act Release No. 12352 (April 20, 1976), 9 SEC Docket 450. 42nd Annual Report at 92.

[88]The examination includes, among other things, a physical inspection of the broker or dealer's books and records and supporting materials and a review of the firm's sales practices.

[89]It may be noted that the self-regulatory organizations have similarly developed and updated their examination manuals and checklists during the fiscal year.

[90]See 6 Securities Investor Protection Corp. Ann. Rep. (1976).

[91]In addition to inviting examiners employed by the self-regulatory organizations to certain of the Commission's training programs, the Commission also works with the self-regulatory organizations to improve their own training programs. The Commission periodically reviews the training efforts of the self-regulatory organizations which hold informal, bi-monthly training programs and more formal annual training sessions for their own examination staffs. In many instances, the Commission's examiners have been invited to attend or participate in such sessions.

[92]In general, Rule 15c3–1 prescribes a lower net capital requirement for firms which neither carry customers accounts nor hold customer funds and securities and for firms which conduct a limited securities business; these are generally smaller brokers and dealers. In addition, the net capital rule provides an "alternative net capital requirement," available at the election of qualified brokers and dealers, which adjusts net capital requirements.

[93]Securities Exchange Act Release No. 13806 (July 28, 1977), 12 SEC Docket 1381.

[94]42nd Annual Report at 96.

[95]Securities Exchange Act Release No. 13832 (August 25, 1977), 12 SEC Docket 1465.

[96]Securities Exchange Act Release No. 12214 (March 30, 1976), 9 SEC Docket 203.

[97]Securities Exchange Act Release No. 13105 (January 11, 1977), 11 SEC Docket 1311. As to persons entering the securities industry after July 1, 1976, the rule is effective immediately. Persons already employed by or associated with entities subject to the rule on that date were exempted until January 1, 1977. On December 23, 1976, the Commission adopted an amendment to Rule 17f–2 extending the January 1, 1977, deadline for fingerprinting the latter class of persons until January 1, 1978, on the condition that 25 percent of those persons required to be fingerprinted under the rule are in fact fingerprinted during each calendar quarter of 1977.

[98]Securities Exchange Act Release No. 13565 (May 23, 1977), 12 SEC Docket 463.

[99]Securities Exchange Act Release No. 13943 (September 9, 1977), 13 SEC Docket 63.

[100]The distinction between the levies on municipal and other OTC securities income has been made because the Commission is relieved of certain rulemaking functions as to SECO firms and associated persons by the MSRB. The MSRB has established fixed and variable fees to defray the costs of its regulatory activities in the municipal securities area which must be paid to that Board by firms engaging in that type of business.

[101]*See* discussion of the new transfer agent rules in Part 1, *supra* at

[102]As of September 30, 1977, the following twelve clearing agencies were registered with the Commission: Boston Stock Exchange Clearing Corporation; Bradford Securities Processing Services, Inc.; The Depository Trust Company; Midwest Clearing Corporation; Midwest Securities Trust Company; Options Clearing Corporation; National Securities Clearing Corporation; New England Securities Depository Trust Company; Stock Clearing Corporation of Philadelphia; Pacific Clearing Corporation; Pacific Securities Depository Trust Company; and TAD Depository Corporation.

[103]Securities Exchange Act Release No. 12857 (October 4, 1976), 10 SEC Docket 657.

[104]Securities Exchange Act Release No. 13428 (April 4, 1977), 11 SEC Docket 2191.

[105]Securities Exchange Act Release No. 13709 (June 30, 1977), 12 SEC Docket 1102.

[106]Securities Exchange Act Release No. 13155 (January 12, 1977), 11 SEC Docket 1424.

[107]Securities Exchange Act Release No. 12642 (July 19, 1976), 10 SEC Docket 1142.

[108]Securities Exchange Act Release No. 12749 (August 31, 1976), 10 SEC Docket 325.

[109]Securities Exchange Act Release No. 12788 (September 13, 1976), 10 SEC Docket 457; Securities Exchange Act Release No. 12789 (September 13, 1976), 10 SEC Docket 457.

[110]Securities Exchange Act Release No. 13456 (April 21, 1977), 12 SEC Docket 42.

[111]*Id.*

[112]*Bradford National Clearing Corporation v. SEC*, No. 77–1547 (C.A.D.C.).

[113]Securities Exchange Act Release No. 13378 (March 16, 1977), 11 SEC Docket 2005.

[114]Securities Exchange Act Release No. 13378 (March 16, 1977), 11 SEC Docket

2004; Securities Exchange Act Release No. 13934 (September 6, 1977), 13 SEC Docket 25.

[115]Securities Exchange Act Release No. 13467 (April 25, 1977), 12 SEC Docket 185; Securities Exchange Act Release No. 13530 (May 11, 1977), 12 SEC Docket 383; Securities Exchange Act Release No. 13800 (July 25, 1977), 12 SEC Docket 1377.

[116]Securities Exchange Act Release No. 13466 (April 25, 1977), 12 SEC Docket 184; Securities Exchange Act Release No. 13600 (June 6, 1977), 12 SEC Docket 768.

[117]Securities Exchange Act Release No. 13277 (February 17, 1977), 11 SEC Docket 1748.

[118]Securities Exchange Act Release No. 13714 (July 1, 1977), 12 SEC Docket 1109.

[119]Securities Exchange Act Release No. 12961 (November 8, 1976), 10 SEC Docket 902.

[120]Securities Exchange Act Release No. 12915 (October 21, 1976), 10 SEC Docket 782: Securities Exchange Act Release No. 13511 (May 6, 1977), 12 SEC Docket 362; Securities Exchange Act Release No. 13876 (August 19, 1977), 12 SEC Docket 1567.

[121]Excluded from membership are brokers and dealers whose business consists exclusively of (1) the distribution of shares of mutual funds, (2) the sale of variable annuities, (3) the business of insurance, or (4) the business of rendering investment advisory services to certain investment companies or insurance company separate accounts.

[122]545 F.2d 754 (1st Cir. 1976), *cert. denied*, 97 S. Ct. 1696 (1977).

[123]Section 3(a) (2) exempts from membership in SIPC persons "whose business as a broker or dealer consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts...."

[124]556 F.2d 98 (2nd Cir. 1977).

[125]542 F.2d 840 (2d Cir. 1976).

[126]Section 3(d) of the SIPC Act provides that the Board of Directors meet at the call of the Chairman. In addition, Section 6 of Article 3 of the by-laws permits a special meeting to be called by the Vice Chairman or at the request of three directors.

[127]*See* discussion, *supra* at p. 148.