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Responding to Bagley's
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Mr. Gary L. Seevers
Acting Chairman
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Mr. Seevers:

Mr. William T. Bagley, former Chairman of the Commodity Futures Trading Commission (the "CFTC"), requested, in a letter to me dated October 24, 1978, that the Securities and Exchange Commission (the "Commission") comment upon topics discussed in a Federal Register notice (43 FR 45039, October 5, 1978) issued by the CFTC concerning the registration of futures associations under Section 17 of the Commodities Exchange Act. Chairman Bagley indicated the CFTC's belief that it could learn from this Commission's experience with respect to the National Association of Securities Dealers, Inc. (the "NASD"), the sole national securities association registered pursuant to Section 15A of the Securities Exchange Act of 1934, as amended (the "Act").

Some of the questions asked in the CFTC's Federal Register notice go beyond the realm of this Commission's experience. We are pleased, however, to share with you the following observations and opinions concerning the operation of Section 15A of the Act and our oversight of the NASD.

I. Historical Background

Shortly after the passage of the Maloney Act, 52 Stat. 1070 (1938), which authorized the registration of national securities associations, a joint committee composed of representatives of the Investment Bankers Conference, Inc. (the forerunner of the NASD) and the Investment Bankers Association indicated that it envisioned the formation of a strong national securities association. The Commission approved of the concept. The Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Doc. No. 95, 88th Cong., 1st Sess., pt 3 at 606 (1963) (the "Special Study"). Moreover, at that time the Commission encouraged the formation of a single national securities association notwithstanding that the statute permitted the registration of national associations organized on regional, functional, or other bases. Id. In that regard, the Special Study quotes a former Commission Chairman as stating the Commission's belief "that the best form of organization would be a strong national association, truly representative, including the small as well as the large elements in the business. It seems to us that a strong national [securities] association can best deal adequately and effectively with the important questions which will arise under [the Act]; and cope effectively with the problems of an industry which is truly national rather than local in character." Id.

In addition, the Securities Acts Amendments of 1975, Pub. L. No. 94-29 (1975) (the "1975 Amendments"), would appear to encourage any registered securities association to admit a wider variety of brokers and dealers to membership than previously had been required by the Act. Section 15A(b) (3) of the Act, as revised by the 1975 Amendments, in effect prohibits a registered securities association from denying membership to any registered broker or dealer on the basis of the broker's or dealer's geographical location and thus precludes the registration of regional securities associations. See H.R. Rep. No. 94-229, 94th Cong., 1st Sess., 98-99 (1975). Section 15A(g) (4) of the Act, which permits the registration of functionally specialized securities associations (*i.e.*, any association whose membership is limited to brokers or dealers engaged in a specific type of business), prohibits any such association from denying membership to any registered broker or dealer who is engaged in business in the association's specialized area, regardless of the amount of such business done by the broker or dealer or any other types of business in which such broker or dealer is engaged. In contrast, prior to the enactment of the 1975 Amendments, Section 15A(b) (3) of the Act permitted the registration of a national securities association which restricted membership on a geographical basis. Nor was there any provision in the Act which explicitly prohibited the registration of a functionally specialized securities association which denied membership to an applicant broker or dealer who either engaged in lines of business other than those specified in the association's rules or who transacted what the association deemed to be an insufficient amount of business in the area(s) covered by the association's rules.

II. Advantages and disadvantages of a single national securities association

As you may know, no securities association other than the NASD has applied for registration with the Commission pursuant to Section 15A of the Act. Thus, the Commission lacks empirical data to compare the relative benefits of single and multiple securities associations for brokers and dealers trading in the over-the-counter market. Based on its oversight of the NASD, however, the Commission believes that some of the more significant advantages and disadvantages which may be associated with a single association encompassing all aspects of the over-the-counter securities market are as follows:

A significant argument which can be made in favor of a single national securities association is that a single securities association with a broad-based membership may be less susceptible to the domination or control of a single firm, group of firms or segment of the securities industry than would a functionally specialized or regionally based association of brokers and dealers. Such domination, if permitted to exist, might allow the dominant parties to (a) subordinate the interests of the entire association to their parochial or proprietary interests, (b) change the nature of the association from a self-regulatory organization to a largely promotional body and (c) use the association to erect barriers to competition. The very size and diversity of a single strong national securities association and the presence of competing interest groups within the association may act to inhibit any particular interest group from dominating the association in this fashion.

Another advantage of having a single national securities association to regulate the over-the-counter market is that it avoids the duplication of regulatory efforts which might otherwise occur in the presence of a multiplicity of securities associations. The broker-dealer community is characterized by the existence of many members which operate nationwide or across regional boundaries and participate in a variety of different types of securities businesses. Thus, a large duplication of regulatory efforts might result from the existence of several regional or specialized organizations designed to regulate different but overlapping segments of the broker-dealer community. Such duplication would waste both industry and Commission resources. In addition, the various associations might adopt inconsistent rules or policies which would confuse or inconvenience dual members.

A theoretical disadvantage of a single national securities association is that the diverse interests of the membership of such an association may delay the implementation of self-regulatory action. A single association is composed of numerous groups which often have diverse or even divergent interests with respect to a particular self-regulatory proposal. However, those interests frequently must be reconciled in order to enlist the support of a majority of the membership for the proposal. The reconciliation of these interests can be an extremely time consuming process.

Another argument against a single national securities association is that the specialized needs or problems of particular segments of the broker-dealer community might be more efficiently and expertly dealt with by specialized securities associations having expertise in specialized areas and a more specific understanding of the particular difficulties which confront their members. It should be noted, however, that in practice, the NASD has tried to deal with these specialized needs or problems by creating a regional substructure and by attempting to assure that, as far as practicable, all segments of the broker-dealer community are represented on NASD governing and policy-making bodies both at the regional and national levels. These steps will be detailed in the next section.

III. Fair representation of the membership of a national securities association and for the limitation of anticompetitive practices

The Commission believes that there are two structural aspects of a national securities association which could be of particular importance in assuring that fair representation is generally maintained and that anticompetitive practices are limited. First, as discussed above, the creation of a strong national association with a broad-based membership may help to achieve both of these ends by making it more difficult for a single firm, group of firms or segment of the industry to dominate the association. Second, adherence to the principle of "one member one vote" may be of some assistance in maintaining fair representation within the association. While the Commission believes that adherence to this principle will generally be useful in assuring fair representation, it recognizes, however, that some deviations may be necessary in order to prevent the interests and needs of particular segments of the securities industry from being submerged in the association. The NASD has taken a number of steps in attempting to assure that all of its members are fairly represented.

The NASD has, for example, attempted to accommodate the needs and interests of members in particular geographical locations by creating a regional substructure. The membership of the NASD is divided into thirteen geographical districts. Each district has a District Committee which is elected by members having business offices in the district. The District Committee, acting as an agent for the NASD, administers the affairs of the NASD at the local level, and serves as the District Business Conduct Committee.

The NASD has attempted to ensure that local interests are represented at the national level as well as at the district level through representation on the NASD's national Board of Governors. Each of the thirteen districts is represented on the Board of Governors by one to five members of the Board. (The apportionment of members of the Board is set forth in Art. IV, Sec. 3 of the NASD's By-Laws.) Candidates for these seats on the Board of Governors are nominated by district nominating committees, or by petition of 10 percent of the NASD members in the district, and elected by the NASD members having places of business in the district. Twenty-one of the twenty-seven members of the Board of Governors are selected in this manner.

The NASD has also attempted to assure representation for and accommodate the needs and interests of its members who engage in specialized aspects of the securities business. The By-Laws of the NASD provide that the Board of Governors shall elect one at-large member of the Board from among the principal underwriter members of investment company shares, and one at-large member of the Board from among those NASD member broker-dealers who are either insurance companies or insurance company affiliates selling securities products such as variable contracts. NASD By-Laws Art. IV Sec. 3(f)-(g). Further, the By-Laws of the NASD charge district nominating committees with assuring that, as far as is practicable, all classes and types of firms engaged in the investment banking or securities business are adequately represented among the candidates they nominate for the District Committees and the Board of Governors. NASD By-Laws Art. IV Secs. 12(a), 22(a). The NASD has also created specialized standing committees (e.g., the Investment Companies Committee and the Municipal Securities Committee) which assist the Board of Governors in developing proposed rules, rule changes, interpretations and general NASD policy in their particular areas of expertise. The membership of each of these committees is drawn largely from NASD members engaged in the type of business in which the standing committee specializes.

While the structure of a national securities association may well play an important role in maintaining fair representation and in limiting anticompetitive practices, it does not appear that that structure by itself could insure the achievement of those ends. The Commission believes that vigilant oversight by the Commission is also a significant factor, particularly with respect to the latter goal. Section 15A(b) (9) of the Act requires that "[t]he rules of the association do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]." When the Commission approves or disapproves proposed rules or rule changes of the NASD, pursuant to Section 19(b) of the Act, when it reviews NASD disciplinary actions pursuant to Section 19(d) of the Act, or when it performs any of its other oversight functions with respect to the NASD, it does so with reference to the requirements of Section 15A(b) (9).

IV. Should membership in a registered national securities association be made compulsory?

As you may know, membership in a registered securities association is not required by the Act or by Commission rules. The Congress, however, in adopting the Maloney Act, allowed national securities associations to create powerful economic incentives for membership by providing that “[t]he rules of a registered securities association may provide that no member thereof shall deal with any non-member professional . . . except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.” Section 15A(e) (1) of the Act (formerly Section 15A(i) (1)). The NASD has adopted such a rule. See NASD Rules of Fair Practice, Art. III, Sec. 25. This rule tends to make membership in the NASD an economic necessity for most brokers and dealers since, in effect, it precludes non-NASD members from obtaining dealer discounts or concessions from NASD member broker-dealers. While the vast majority of brokers and dealers doing business with the public have chosen to join the NASD, a number of others have not become members.

At the time of the Special Study (1963), the Commission believed that new efforts were necessary to raise industry standards with respect to qualifications, competence and financial responsibility, and that these needs could best be met through the adoption of self-regulatory rules. The Commission also believed that rules requiring compliance with just and equitable principles of trade could best be developed, interpreted, and enforced by a self-regulatory organization. The Commission was concerned, however, about the possibility that a broker-dealer could effectively “exempt” itself from such rules by failing to join such an organization.

SEC Legislation: Hearings before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, on H.R. 6789, H.R. 6793 and S. 1642, 88th Cong. 1st Sess., 250 (1963) (Testimony of William L. Cary, Chairman, Securities and Exchange Commission).

Therefore, in 1963 the Commission supported a proposed amendment to the Securities Exchange Act of 1934 which, in effect, would have required that any broker or dealer who effected any over-the-counter securities transactions be a member of a registered national securities association. Id. at 126-28. Persons opposed to compulsory membership argued that brokers and dealers should not be regulated by, or forced to supply information to, their competitors. H.R. Rep. No. 1418, 88th Cong., 2nd Sess. 12 (1964). The Congress determined “as a matter of policy that compulsory membership should not be required of brokers and dealers.” Id. Instead, the Congress, in the Securities Acts Amendments of 1964, gave the Commission the necessary authority to insure that non-member brokers and dealers (also referred to as “SECO broker-dealers”) were subjected to regulation comparable to that which registered national securities associations imposed on their members. Id. See also Sections 15(b) (7)-(9) of the Act. As a consequence, the Commission has established substantially comparable regulations for brokers and dealers who are not members of a registered national securities association. See Securities Exchange Act Rules 15(b) (10) (1) et seq. See also Securities Exchange Act Release No. 9420 (December 20, 1971) (statement by the Commission regarding the comparability of NASD and SECO regulation and the relevance of published NASD standards and rules to non-member broker-dealers and their associated persons). It must be

recognized, however, that although the Congress rejected the concept of compulsory membership in 1964, it left intact the statutory provisions which permitted a national securities association to create powerful economic incentives to membership.

Many of the other issues raised in your Federal Register notice, such as whether contract markets should be permitted to join a futures association, do not arise or have counterparts in the securities markets. Thus, the Commission did not feel that it was in a position meaningfully to address those issues based on its special expertise and experience. Should you wish to review the documented history and operations of Section 15A of the Act, and of the NASD, including expressions of the Commission's and others' views on various policy issues concerning the purposes and operations of self-regulatory organizations, we recommend the following material:

- (1) The Legislative History of the Securities Act Amendments of 1975.
 - (a) Securities Act Amendments of 1975 -- Oversight: Hearings before the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess. (1977).
 - (b) H.R. Rep. No. 94-229, 94th Cong. 1st Sess. (1975) (conference committee report)
 - (c) S. Rep. No. 94-75, 94th Cong. 1st Sess. (1975)
 - (d) H. R. Rep. No. 94-123, 94th Cong. 1st Sess. (1975)
 - (e) Securities Act Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking Housing and Urban Affairs, 94th Cong. 1st Sess. (1975)
 - (f) National Securities Market System Act of 1973: Hearings Before a Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 93rd Cong., 1st Sess. (1973).
 - (g) S. Rep. No. 93-13, 93rd Cong. 1st Sess. (1973) ("Securities Industry Study").
 - (h) Securities Industry Study: Hearings Before the Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92nd Cong., 2d Sess (1972).
 - (i) Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 92nd Cong., 2d Sess. (1972).

- (2) The Legislative History of the Securities Acts Amendments of 1964.
 - (a) H. R. Rep. No. 1418, 88th Cong., 2d Sess. (1964)
 - (b) S. Rep. No. 379, 88th Cong., 1st Sess. (1963)
 - (c) SEC Legislation: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. 1642, 88th Cong., 1st Sess. (1963)
 - (d) Investor Protection: Hearings Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce H.R. 6789, H.R. 6793 and S. 1642, 88th Cong., 1st Sess. (1963)
- (3) Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Doc. No. 95, 88th Cong., 1st Sess. Chaps. II, III, IV, VII, XI, XII (1963)
- (4) The Legislative History of the Maloney Act
 - (a) H.R. Rep. No. 2307, 75th Cong. 3d Sess. (1938)
 - (b) S. Rep. No. 1455, 75th Cong. 3d Sess. (1938)
 - (c) Regulation of the Over-the-Counter Markets: Hearings Before Subcomm. of the House Comm. on Interstate and Foreign Commerce on S. 3255 and H.R. 9634, 75th Cong. 3d. Sess. (1938)
 - (d) Regulation of Over-the-Counter Markets: Hearings Before the Senate Comm. on Banking and Currency on S. 3255, 75th Cong. 3d Sess. (1938)
- (5) Annual Reports of the Securities and Exchange Commission -- 1939 – date.

We hope that this letter will prove useful to you in assessing the proposed standards for the registration of national futures associations and in your oversight of such associations. If you need any further information or assistance, please feel free to contact me or Michael P. Maloney, Assistant Director, Office of Self-Regulatory Oversight, Division of Market Regulation.

Sincerely,

Harold M. Williams
Chairman