

**NASD**

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST - WASHINGTON D.C. 20006

May 27, 1971

Honorable William J. Casey  
 Chairman  
 Securities and Exchange Commission  
 500 North Capitol Street  
 Washington, D. C. 20549

CHAIRMAN'S OFFICE  
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SEC. & EXCH. COMM.

Dear Chairman Casey:

This will acknowledge your letter of April 27, 1971, referring to the Securities and Exchange Commission's obligation, pursuant to the provisions of Section 11(h) of the Securities Investor Protection Act of 1970, to furnish Congress before the end of 1971 a list of unsafe and unsound practices of broker/dealers, the steps being taken under the authority of existing law to eliminate them and recommendations concerning additional legislation if such is felt necessary. Your letter thus invites the Association to submit comments as follows:

- (a) a detailed list of practices of broker/dealers which the Association deems to be unsafe or unsound;
- (b) a statement of steps which the Association has taken in the past and those which it is taking or is considering taking to eliminate such practices, and
- (c) the Association's views as to the necessity for additional regulations by the Commission and/or federal legislation.

I assume your inquiry concerns "unsafe and unsound practices" of broker/dealers "in conducting their business" as distinguished from improper or illegal practices generally which are the subject of an extensive system of regulation by both the Commission and the Association. Thus, your inquiry concerns those practices which have the potential to, or actually do, adversely affect the operational capability of broker/dealers or their financial responsibility in meeting their obligations to the public and other broker/dealers. I will attempt to respond in that context.

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In general response to your letter, I think it would be appropriate to call your attention to testimony given by representatives of the Association on February 27, 1969, before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives. 1/ The Association at that time reviewed its regulatory efforts in a variety of areas since the Special Study of Securities Markets was completed in 1963 including a detailed tabulation of all rule changes adopted since that time. 2/ The Association also detailed its efforts to implement the Special Study and the Securities Acts Amendments of 1964, the development of NASDAQ, its efforts to dampen speculation and the many actions it took to curb the then very critical "fails" problem among other matters including the development of a national clearance system which was then still in its embryonic stage. Many of the actions taken by the Association at that time in connection with the "fails" and other operational problems have been carried forward to the present time and shall continue into the indefinite future. In many respects they have matured and become much more effective.

Ease of Entry Into The Business --  
Ineffective and Inefficient Management

Many of the problems of the recent past resulted from a lack of training and a lack of experience on the part of personnel, including management personnel, and inadequate capital. On the other hand, much documentation is available to show that inattention to business by supposedly experienced persons gave rise to the problems of some firms.

Generally speaking, therefore, ease of entry into the securities business by inadequately trained persons who sometimes open their own firms with marginal capital, represents a continuing, serious and primary problem of the industry. New regulations can improve this situation easily but such cannot as easily cure problems which arise from bad management. Close surveillance by the regulatory agencies and the strict

1/ Hearings before Subcommittee on Commerce and Finance of Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong., 1st Sess., ser. 91-9, pp. 195-240, 324-442.

2/ We would be happy to update this tabulation and submit it to you if you so desire.

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implementation by them of regulations designed to protect the public is essential in that respect. The Association has and is continuing to take action in both of these problem areas which inevitably result in operational and/or capital difficulties.

Problems in the operational area surfaced during the 1968 to 1970 period as a result of the so-called "paperwork crunch" caused by increased volume. The factors discussed above obviously aggravated the problem and in many cases inadequate internal controls resulted in capital problems and caused some firms to go out of business. Inordinate amounts of fails to deliver and to receive further aggravated things. During this period, the Association undertook a comprehensive program of examination and close surveillance of all members. This is described in detail in the referred to testimony before the House Committee commencing at page 181 of the record. Current activities in this respect were described in detail in recent correspondence with your Director of the Division of Trading and Markets, Mr. Irving M. Pollack, copies of which are enclosed as Exhibit No. 1. We believe this program has assisted us greatly in identifying firms with operational and financial difficulties and, when necessary, in taking appropriate regulatory actions.

On the question of training and experience of individuals entering the business, you are aware that the Association today requires examinations of registered representatives and registered principals. However, no examination, regardless of how difficult it is, can replace sound experience in any business. In this connection, the Association is presently conducting a study of its qualification examination program, partially with the assistance of an outside consultant, for the specific purpose of raising the level of competence required of registered representatives entering the securities business and registered principals undertaking the management of firms. At present we do not believe any additional regulatory or legislative action is needed in this respect though we will have to await the final report of our study before making any definite conclusions.

#### Inadequate Capital Requirements

Present minimum capital requirements are at best too low and the significance of this is magnified when bad management is present. With this in mind, the Association, on July 29, 1970, established a capital

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standards committee which has met with the staff of the SEC on several occasions. The purpose of this committee is to establish more rigid minimum and other capital requirements for members of the Association and it is well along in its work. It is also looking into the possibility of requiring a broker's blanket bond for all members of the Association. The Association has not been successful in that respect in previous attempts, however, because of the requirements of the insurance industry.

We do not believe we need any additional regulatory or legislative action to do what the committee presently has in mind. A copy of this committee's report to the latest meeting of the Association's Board of Governors is attached hereto as Exhibit No. 2.

As a result of a recommendation of the committee, the Association has already instituted a requirement that members immediately report to the Association when their net capital ratio exceeds 15 to 1. This, in addition to other procedures of the Association, provides an early warning of potential trouble ahead and appropriate regulatory surveillance action is then undertaken in the field.

"Fails"

I have above referred to the "fails" problem which has been extant in the securities industry over the past two to three years. The problem has not been eliminated but it has been brought under control notwithstanding the upsurge in volume over the past few months. <sup>3/</sup> This is still a very definite problem in the securities industry but machinery has been set in motion to eliminate it as a problem in the not too distant future. In this connection, you are aware of the establishment of the National Clearing Corporation in 1969 for the purpose of developing a nationwide clearing system for the over-the-counter market. This proposed system will merge open securities

<sup>3/</sup> Attached hereto as Exhibit No. 3 is a summary of all fails to receive and fails to deliver figures by month from May, 1968.

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positions daily and carry them forward on a perpetual basis leaving all items in the system until settlement occurs. The system will operate through a series of regional clearance centers and it is being designed to include a securities depository feature as well as procedures for dividend accounting and processing of transfer instructions. As part of this program the National Clearing Corporation acquired the National Over-The-Counter Clearing Corporation in the fall of 1970. This acquisition will assist in clearing over-the-counter securities transactions in the New York City area until the National Clearing Corporation's somewhat different system can be inaugurated in that area. It is anticipated that the first NCC clearing center will be established in late 1971. We have previously detailed our efforts in this respect to the Commission. The only thing that can be added at this time is that this work is proceeding on a top priority basis.

Inability of the Association to Promptly  
Deal With Some of These Problems

On many occasions in the past the Association has, as a result of its examination program, seen danger signs in one or the other of these areas but it has been powerless to take effective, swift action without, ironically, the cooperation of the broker/dealer involved. If rules are violated, a disciplinary proceeding can, of course, be instituted. The procedural steps which must then be followed before any restrictions can be imposed by the Association takes a considerable period of time. During the interim, unless the Securities and Exchange Commission has obtained an injunction, the member could continue to do business as usual.

Many times a rule violation is not involved but it is apparent that a firm is headed for trouble because of operational inadequacies or a rapidly deteriorating capital situation. Perhaps the firm is handling a larger volume of transactions than it can process with the facilities and personnel available. As a result, its record-keeping falls further and further behind and it becomes difficult, if not impossible, to accurately compute capital. Immediate corrective action is obviously necessary if the public is to be protected from injury but the only immediate thing the Association can presently do is to attempt to persuade the member to accept certain non-binding restrictions. Actually, we have been very successful in doing this especially during the most critical days of the

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"paperwork crunch" and, while resistance was encountered, nearly all firms to whom restrictions were suggested eventually complied. Some of the types of restrictions imposed are as follows:

1. limitations on the number of daily transactions;
2. restrictions on market making activities and trading in new issues;
3. prohibitions against solicited or unsolicited transactions with the public;
4. agreements to increase firm capital and employ additional personnel;
5. agreements to join the National Over-The-Counter Clearing Corporation;
6. requiring customers' securities to be in hand before acceptance of orders;
7. prohibitions against executing any orders in a security in which a firm has sold fails;
8. limiting the hiring of additional registered representatives.

As noted, the Association does not have the authority to require a member to accept such restrictions. Consideration should be given to the enactment of legislation enabling the Association to take summary action in certain well defined situations pursuant to criteria spelled out therein. It is recognized that due process requirements may make such a course of action difficult but the job of self-regulation seems to break down if nothing can be done when a situation is discovered which leads skilled observers to reasonably conclude that the public will be injured if it is not curtailed.

#### Financial Reporting

There is a serious need of coordinating the reporting requirements of all self-regulatory organizations and the Securities and Exchange Commission. The duplicative nature of such is expensive and adds to the

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operational and back office problems referred to above. The Association has met with the New York and American Stock Exchanges and has developed draft uniform forms which, hopefully, will eventually eliminate the necessity of filing different reports with the various organizations. Ideally, such a uniform form would even eliminate the Commission's Form 17a-5. If this were accomplished a member would only have to fill out one form and file a copy with each of the various regulatory agencies with which it is affiliated. No regulatory or legislative action is needed to accomplish this.

#### Free-Credit Balances

The Association is in agreement that some form of additional regulation in this area is necessary for the protection of the public and that it may even be desirable to impose a reserve requirement. Such should not be unreasonable, however, and should not be anywhere near the 100% level suggested by the Division of Trading and Markets. We have already met with the New York and American Stock Exchanges on this subject and anticipate submitting an industry proposal in the very near future.

#### Segregation Practices

The Association recognizes that problems exist in connection with the segregation of securities. Many, but certainly not all, of those problems result from systems' inadequacies rather than improper conduct. To the extent that both situations exist they should be corrected but in doing so care must be exercised to insure that new problems are not created. We have already consulted with the New York Stock Exchange on this matter and anticipate further consultations in the near future.

#### Trading in Shell Corporations

Periodically excessive trading in shell corporations has occurred and the Commission is aware of all of the ramifications of such including the adverse impact in many cases upon the public interest. It has spoken to such in at least two releases, Securities Exchange Act Release No. 8638 and No. 8909. It appears there is substantial activity in this area again.

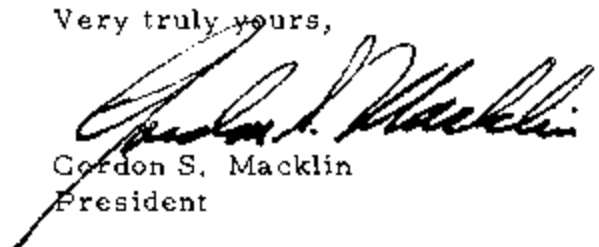
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Experience has shown numerous instances of rigged markets resulting ultimately in detriment not only to the public but to other broker/dealers as well. Some form of control of this activity is necessary and the Commission attempted such in its proposed Rule 15c2-11 contained in the referred to Release No. 8909 which has not been acted upon. The Association offered extensive comment on that proposal emphasizing its desire to see appropriate and meaningful regulation in this area. We did not believe the rule in its proposed form did the job, however, because of the many practical problems it created.

The recurring problem of trading in shell corporations should be met by effective regulatory action by the Commission.

The above represents what I believe to be some of the more important problem areas encountered by broker/dealers in the conduct of their businesses. I am sure there are others. Some which have had an adverse reaction on broker/dealers' operations are not caused by broker/dealers themselves. Those problems involve transfer agents, banks and others and are not easy to solve. Some of these problems are being attacked in a joint industry undertaking through the efforts of BASIC. The Association has participated and cooperated with this group since its inception. It is still too early to tell how effective its efforts will be but the total effect of this joint industry undertaking cannot do anything but help the securities industry and assist in alleviating a variety of operational problems which broker/dealers experience.

Very truly yours,

  
Gordon S. Macklin  
President

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RG 266 UD-UP Entry 1

Subj. Files 34-81

Box 71 Folder "National Association of Securities Dealers, vol. 17"