ADMINISTRATIVE PROCEEDING
FILE NO. 3-2428

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SECURITIES & EXCHANGE COMMISSION

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 16-1-1

INITIAL DECISION

Washington, D.C.
May 28, 1971

David J. Markun
Hearing Examiner

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APPEARANCES: Martin Moskowitz, Special Counsel, and Richard Gordon, Attorney, for the Division of Trading and Markets.

Warren G. Elliott, General Counsel; Stephen B. Middlebrook, Counsel; George N. Gingold, Assistant Counsel; and (for PALIC) Larry D. Gilbertson, General Counsel, for Aetna Life and Casualty Company, Aetna Financial Services, Inc., and Participating Annuity Life Insurance Company.

Lloyd J. Derrickson, Vice President and General Counsel; Frank J. Wilson, Vice President and Associate General Counsel; and Dennis C. Hensley, counsel, for respondent National Association of Securities Dealers, Inc.

BEFORE: David J. Markun, Hearing Examiner

The Proceeding

This public proceeding was instituted by an order of the Commission dated April 24, 1970, pursuant to Section 15A(k)[1] of the Securities Exchange Act of 1934 ("Exchange Act"), to determine whether, as contended by the Commission's staff, the National Association of Securities Dealers, Inc., ("NASD"), has improperly construed or applied the authority granted it under Section 15A(i)[2] of the Exchange Act, or Article III, Section 25 of its Rules of Fair Practice ("Rule 25") in particular situations mentioned in the order, and what, if any, remedial action is necessary or appropriate to effectuate the purposes of the Exchange Act.

Aetna Life and Casualty Company and two subsidiaries, Aetna Financial Services, Inc. and Participating Annuity Life Insurance Company, sometimes collectively referred to herein as "Aetna", which had petitioned the Commission for institution of a proceeding under Section 15A(k) of the Exchange Act for abrogation of the NASD's Rule 25(b)(2), were accorded the status of parties under the Commission's Rules of Practice.[3]

An evidentiary hearing was held over a period of seven days and oral argument was heard under 17 CFR 201.16(g) after the issues of fact and law had been extensively briefed by all parties.

The Parties

The NASD, respondent herein, is a national securities association registered with the Commission pusuant to the provisions of the Maloney Act, Section 15A of the Exchange Act.[4] It is the only association presently registered or which has ever been registered under that authority

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1/ 15 U.S.C. §78o-3(k)

2/ 15 U.S.C. §78o-3(i)

3/ 17 CFR 201.9(e)

4/ 15 U.S.C. §78o-3

and it currently embraces some 4500-4800 registered broker-dealers throughout the United States, some 90-95% of all broker-dealers registered under Section 15(b) [5/] of the Exchange Act. In keeping with the design of the Maloney Act, the NASD has authority thereunder to issue rules governing its members, subject to various statutory standards and subject also to the Commission's right to disapprove such rules or supplements or amendments thereto (§15A(e),(j)) and to abrogate or modify such rules once approved (§15A(k)(1)). It is the meaning and legality of one of the NASD's rules, its Rule 25(b)(2), as construed and applied in given factual situations, that is here in question.

Aetna Life and Casualty Company ("Aetna"), chartered in 1967 under Connecticut law, itself does no significant amount of business. Its largest subsidiary is Aetna Life Insurance Company ("Aetna Life"), which as of the end of 1969 accounted for over three fourths of the assets of Aetna and its subsidiaries. Aetna owns 97.2% of the outstanding capital stock of Participating Annuity Life Insurance Company ("PALIC"), which is engaged almost exclusively in writing annuity contracts, principally variable annuities, which provide retirement benefits related to investment experience. Aetna also owns all the capital stock of Aetna Financial Services, Inc. ("Financial"), which in April of 1970 commenced selling shares of Aetna Fund, Inc., a mutual fund registered under the Investment Company Act of 1940 [6/] as an open-end investment company. Both PALIC and Financial are registered as broker-dealers under the Exchange Act and PALIC is also registered as an open-end management investment company under the 1940 Act.

5/ 15 U.S.C. §78o(b)

6/ 15 U.S.C. §80a-1 *et seq*.

Neither PALIC nor Financial is a member of the NASD. Both are therefore SECO broker-dealers subject to regulation by the Commission in accordance with the 1964 amendments [7/] to the Exchange Act providing for such regulation of broker-dealers registered under the Act who are not members of the NASD or any other registered national securities association.

The Division of Trading and Markets is the entity of the Commission's staff charged with functions respecting the Commission's supervisory powers under Section 15A of the Exchange Act over the NASD.

Factual Context of the Issues

The legal issues presented for determination can best be understood in the context of the pertinent factual background.

Aetna Life, a Connecticut insurance company organized in 1853, is admitted to do business in every state of the United States, the District of Columbia, Guam, Puerto Rico, and every Canadian province save Prince Edward Island and writes substantially all kinds of life insurance except industrial policies. By far the greater part of Aetna Life's premium income in recent years has come from the sale of group contracts rather than individual contracts. Thus, in 1969, group contracts accounted for approximately 87½% or over $1,500,000,000 of Aetna Life's premium income.

The sale of group insurance products is typically negotiated with employers who are interested in making such products available to their employees as part of a general employee-benefit program. Group insurance makes employee benefits available at a lower cost than an individual employee would incur if he dealt directly with an insurance company.

7/ 78 Stat. 565

Most employers of any substantial size purchase their group insurance by utilizing the services of an insurance broker or consultant rather than by direct dealing with the insurance company. They do this because it costs no more to utilize the services of the insurance broker and because most employers feel they need expert assistance in evaluating and comparing the variety of contracts and plans offered by various insurance companies. Thus, about 90% of the group insurance sold in connection with employee-benefit plans is sold with the assistance of these insurance brokers and consultants.

The insurance broker or consultant receives his commission[8/] from the insurance company making the sale. However, as a practical matter, both the insurance company and the insurance broker view the insurance broker as representing his employer-client rather than the insurance company. The insurance brokerage firm considers that it has a strong proprietary interest in the employer-customer account, and regards the insurance company as a "supplier" who performs service functions only.

An insurance broker is utilized by an employer to help him develop or improve an appropriate employee-benefit program. The insurance broker develops a full set of specifications based on and adapted to the employer's needs and circulates those specification to various insurance companies. The insurance companies circulated are selected by the insurance broker based upon knowledge of such companies gained from regular visits from insurance company representatives eager to discuss new product developments. When all the bids are in, the

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8/ Normally this involves a first-year commission and nine somewhat smaller annual renewal commissions.

insurance broker generally gives the employer a single or perhaps two alternative recommendations. Once the employer selects or approves the insurance company, a three-way meeting generally takes place between employer, insurance broker, and insurance company representatives to develop plans for implementing the program selected, including design of employee-enrollment material. The "servicing" of a group insurance contract is generally done jointly (in varying degrees of participation) by the insurance broker and salaried representatives of the insurance company.

The insurance-brokerage business is a highly concentrated one and appears destined to become more so as larger firms acquire smaller ones through merger. The market is essentially controlled by the hundred to two hundred largest insurance brokerage firms, which are generally retained by the major employer corporations. The major brokerage firms handle 60 to 70 percent of Aetna Life's business and two of the largest firms alone handle 15 to 19 percent of Aetna Life's group business.

As has been done by the major life insurers generally,[9/] Aetna in recent years has gone into the selling of registered equity products. It currently markets open-end mutual fund shares (Aetna Fund) through Financial and variable-annuity shares through VALIC (acquired by Aetna in 1967).

9/ As of March 1, 1970, there were 161 life insurers which were themselves members, or had one or more broker-dealer subsidiaries which were members, of the NASD. Thirty two (32) of these were selling their own funds and over 100 of the remaining companies were selling unrelated funds. Thirty nine insurers were offering variable annuities. Institutional Investors Study Report of the Securities and Exchange Commission, Vol. 2, p. 523 (House Document No. 92-64, Part 2, 92d Congress, 1st Session).

Aetna's assessment of the various relevant factors has persuaded it that the most promising long-range method for marketing its equity products lies in their group marketing, i.e. by including such equity products as elements in the total employee-benefit package of its regular group-insurance customers. In short, Aetna visualized selling its equity products to its existing group policyholders via the same insurance brokerage firms through whom they have regularly sold group life insurance, pension plans, salary continuation, health insurance and other groups plans.[10/]

The use of equity products in employee-benefit programs is a rapidly developing field. There is growing interest, particularly among corporate employers, for their inclusion. This has resulted from the increased sophistication of employers attempting to keep costs in line in an inflationary economy, improvements in union-negotiated demands, and the increasing availability of such equity products through the same channels that had for years provided the more standard employee-benefit components. The inclusion of equity products in employee-benefits programs has come to be regarded widely as the workingman's most effective and most promising means for acquiring equity ownership. As one witness put it, it is his means for getting "plugged into the economy."

Since mutual funds and variable annuities are both "securities" within the meaning of the federal securities laws[11/] broker-dealers distributing them in interstate commerce must be registered under the Exchange Act, and insurance brokerage firms therefore had to take appropriate

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10/ Aetna has some thirty to forty thousand group policies outstanding; its marketing strategy is to interest these same holders in its equity products.

11/ SEC v. Variable Annuity Co., 359 U.S. 65 (1959); Prudential Insurance Co. v. SEC, 326 F.2d 383 (1964) cert. denied 377 U.S. 953.

steps to meet this requirement if they were to handle these products. Most of the larger insurance-brokerage firms have met the problem by forming subsidiaries that are broker-dealers registered under the Exchange Act and members of the NASD. As members of the NASD, these broker-dealer subsidiaries of the insurance brokerage firms are able to handle equity products underwritten by principal underwriters who are also members of the NASD, but they are unable to handle products underwritten by underwriters such as PALIC and Financial who are not NASD members but instead are SECO-regulated organizations. This results from the NASD's application of Rule 25(b)(2), which provides:

> "(b) Without limiting the generality of the foregoing, no member shall:
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> * * *
>
> (2) join with any nonmember broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof;"

To avoid the restriction resulting from Rule 25(b)(2) PALIC representatives sought to persuade two major insurance brokerage firms to establish dual, independent subsidiary broker-dealer firms, one to be an NASD member and the other to be SECO regulated, so that the NASD member broker-dealer subsidiary could handle NASD-underwritten equity products and the SECO-regulated broker-dealer subsidiary could handle the equity products underwritten by VALIC and Financial and other SECO-regulated broker-dealer underwriters. These efforts were not successful, inasmuch as the NASD took the position that under such an arrangement the contemplated NASD broker-dealer subsidiary would be in violation of NASD Rule 25(b)(2)'s anti-joining provision because it and the SECO-regulated broker-dealer subsidiary would be under common ownership and thus be "affiliates" of one another.

Thus, the insurance broker must choose between formation of a broker-dealer subsidiary that is an NASD member or one that is SECO regulated. Under the NASD's application of its Rule 25(b)(2) it cannot have subsidiaries in both camps. If it establishes a SECO broker-dealer it closes the doors to a large part of the market otherwise available to it as an NASD member, since Section 25(a) of the NASD's Rules prevents the SECO broker-dealer subsidiary from receiving commissions on any product underwritten by an NASD member. And if the insurance brokerage firm establishes an NASD broker-dealer subsidiary, no commissions can be received from PALIC or Financial or other SECO underwriters because of the NASD's application of its Rule 25(b)(2).

A variation on the concept of dual broker-dealer subsidiaries was also tried by some insurance-brokerage firms. Here the procedure was to organize one broker-dealer subsidiary which became an NASD member and as an employee of such subsidiary there would be one or more persons who were also qualified as registered securities representatives ("associated persons") of a SECO-regulated organization, namely PALIC, the intent being that these individuals could handle the equity products underwritten by PALIC and Financial. Here again, the NASD concluded that its Rule 25(b)(2) precluded such an arrangement on the theory that it would involve the NASD-member broker-dealer's joining with the SECO-regulated representative or the firm he represented.

Other insurance broker firms (generally speaking, the smaller ones) have as yet not formed broker-dealer subsidiaries either in the NASD or SECO-regulated camps. Some of these, however, do number among their employees individuals who are registered securities representatives either with an NASD-member broker-dealer or with a SECO-regulated broker-dealer, or both

classes of employees. This device enables the insurance-brokerage firm to accommodate its customers by enabling it to "handle" the equity products, but it results in no financial benefit to the insurance brokerage firm because of the rule precluding the registered representative--employee from sharing his commissions with the insurance-brokerage firm. For this and other reasons this expedient does not afford a long-range, viable method whereby insurance brokerage firms can handle registered equity products.

The NASD's interpretation and application of its Rule 25(b)(2), along with Rule 25(a), also precludes distribution of mutual fund shares and variable annuities underwritten through paralled but separate NASD and SECO distribution channels under the concept of "parallel underwritings". Under this approach an issuer of mutual funds or variable annuities would arrange for completely independent broker-dealer entities to serve as principal underwriters of the security, one such underwriter being a member of the NASD and the other SECO regulated. The two would be independent legal entities and would operate completely independently of one another, one distributing through NASD broker-dealers and the other through SECO regulated broker-dealers. The distribution efforts of each would be unrelated to and not dependent upon those of the other.

Various kinds of parallel underwritings have been proposed or contemplated. In the purest form, the issuer is not affiliated with either underwriter and the two underwriters are not affiliated with one another. In other arrangements the issuer would be affiliated with either of the underwriters but the other underwriter would not be affiliated with the issuer or its affiliate underwriter. And, lastly, an issuer might be affiliated with both of the underwriters.

The NASD concluded that under any such parallel-underwriting arrangement its NASD member would be "joining" in the distributions and thus violating Rule 25(b)(2).

The record establishes unmistakeably that Rule 25(b)(2) as construed and applied by the NASD, seriously impairs Aetna's ability to market its mutual fund shares and variable annuity contracts to its group customers via the traditional avenue for reaching such customers,i.e. through the insurance-brokerage firms. Indeed, the use of this traditional method is virtually foreclosed since very few insurance-brokerage firms have found it economically rewarding to form a SECO broker-dealer subsidiary. The record establishes further that, given the nature of the insurance business, and the role therein of the highly-concentrated insurance-brokerage firms, going directly to the customer rather than through the insurance brokers does not present a workable alternative.[12/] Without an ability to market effectively its group equity products, Aetna will be at a competitive disadvantage because it will be unable to offer a full range of products and its ability to do "account selling" will therefore be impaired.[13/] Although the financial detriment sustained by Aetna as a result of this impediment cannot be precisely quantified, it is abundantly clear that Aetna, based on its established position in the group life insurance field as one of the largest and longest-established companies, could reasonably expect substantial sales in this growing equity market but

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12/ At least one major insurance-brokerage firm in Chicago has declined to deal with Aetna representatives because Aetna on one occasion had by-passed the firm and gone directly to a customer. As one witness from an insurance-brokerage firm put it in reflecting a typical attitude of the insurance-brokerage community: "the insurance companies go to the client through us and with us, but never around us." However, the record contains no support for the NASD's contention that the conduct of insurance-brokerage firms is violative of the antitrust laws. The record shows no concerted action.

13/ Insurance brokerage firms and their clients both generally would prefer that the entire employee-benefits package come from one insurance company, because of administrative economies.

for the impediments it has encountered. 14/ It does not follow from this, of course, that Aetna is entitled to relief by way of abrogation of Rule 25(b)(2); whether such relief is indicated must turn on (1) the legality of the rule as applied and (2) the presence or absence of facts meeting the criteria for abrogation set forth in §15A(k)(1) of the Exchange Act.

Legal and Factual Issues

The Commission's Order for Proceeding was accompanied by three attachments: (1) a letter dated April 2, 1968, from its Director of the Division of Trading and Markets to the President of the NASD in which six questions were asked in respect of the applicability of Rule 25(b)(2) of the NASD's Rules of Fair Practice; (2) a letter dated March 21, 1969, from the President of the NASD responding to the April 2, 1968, letter, and (3) a memorandum of the Division of Trading and Markets in response to the NASD's letter of March 21, 1969. These documents set forth the factual background out of which the issues presented in this proceeding arose.

The six questions raised by the Division's staff in its letter, to which the NASD responded in the negative in each instance, are as follows:

1. Can an NASD member which regularly engaged in the retailing of securities (Bache, Merrill, etc.) sell variable annuities or mutual fund shares whose principal underwriter is a SECO broker-dealer?

2. Would your answer to question 1 be different if the variable annuities were sold not only by the NASD member but also by the SECO underwriter's retail sales force?

3. Can an NASD member sell shares of a traditional mutual fund (Fidelity, Wellington, etc.) if an affiliate of such member is a SECO firm whose variable annuity securities are sold by the same personnel?

14/ There are some 15 companies actively engaged in the sale of group annuities and in 1970 many of them had their best year.

4. Can an NASD member continue to have as a registered representative a salesman who wishes to sell variable annuities as an associated person of a SECO broker-dealer, if the SECO firm (an insurance company) and the NASD member are not under common control?

5. Can an NASD member who retails securities serve as principal underwriter for variable annuities or mutual fund shares for the purpose of selling them through NASD members if the issuer also utilizes a SECO principal underwriter for the purpose of distributing the same security through SECO members? (This question on parallel underwritings assumes that the NASD principal underwriter is not affiliated with the SECO principal underwriter.) Would your answer be different if the issuer itself--say an insurance company -- were a SECO broker-dealer serving as principal underwriter for the distribution of the variable annuity through SECO dealers?

6. Can an NASD member who retails securities, after deciding to set up a new mutual fund and serve as its investment adviser, form a SECO broker-dealer affiliate to serve as the sole principal underwriter of the new mutual fund if the SECO principal underwriter distributed the shares of that fund:

   (a) only through SECO broker-dealers?

   (b) both through SECO broker-dealers and NASD members?

The Division in its Memorandum found no objection to the Association's negative response to questions 3 and 6 and such questions are therefore not in issue -- but disputed the negative answers to questions 1, 2, 4 and 5.

Article III, Section 25 of the NASD's Rules of Fair Practice ("Rule 25") in its entirety states as follows:[15/]

"(a) No member shall deal with any non-member broker or dealer 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.

15/ CCH NASD Manual, Rules of Fair Practice, Article III, Section 25, p. 2098.

"(b) Without limiting the generality of the foregoing, no member shall:

(1) in any transaction with any non-member broker or dealer, allow or grant to such non-member broker or dealer any selling concession, discount or other allowance allowed by such member to a member of a registered securities association and not allowed to a member of the general public;

(2) join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof; or

(3) sell any security to or buy any security from any non-member broker or dealer except at the same price at which at the time of such transaction such member would buy or sell such security, as the case may be, from or to a person who is a member of the general public not engaged in the investment banking or securities business.

" (c) The provisions of paragraphs (a) and (b) of this rule shall not apply to any non-member broker or dealer in a foreign country who is not eligible for membership in a registered securities association, but in any transaction with any such foreign non-member broker or dealer, where a selling concession, discount, or other allowance is allowed, a member shall as a condition of such transaction secure from such foreign broker or dealer an agreement that, in making any sales to purchasers within the United States of securities acquired as a result of such transactions, he will conform to the provisions of paragraphs (a) and (b) of this rule to the same extent as though he were a member of the Corporation.

" (d) For the purpose of this rule, the term 'non-member broker or dealer' shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security, otherwise than on a national securities exchange, who is not a member of any securities association, registered with the Commission pursuant to Section 15A of the Act, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances or commercial bills.

" (e) Nothing in this rule shall be so construed or applied as to prevent any member of the Corporation from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms."

This provision of the NASD's Rules was issued pursuant to Section 15A(i) of the Exchange Act (added by the Maloney Act) which, in its entirety, provides as follows: 16/

"(1) The rules of a registered securities association may provide that no member thereof shall deal with any non-member broker or dealer (as defined in paragraph (2) of this subsection) 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.

(2) For the purpose of this subsection, the term 'non-member broker or dealer' shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange, who is not a member of any registered securities association, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, or commercial bills.

(3) Nothing in this subsection shall be so construed or applied as to prevent any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms."

The primary attack on the NASD's application of Rule 25(b)(2) by the Division and by Aetna is twofold: they argue, first, that, properly understood, Rule 25(b)(2) prohibits the flow of commissions or concessions in only one direction, i.e. it forbids payment by an NASD member to a non member but not the receipt by an NASD member of commissions or concessions from a non member, and, alternatively, they argue that if Rule 25(b)(2) does in fact bar the receipt by an NASD member of commissions from non members it exceeds the statutory authority conferred under Section 15A(i) of the Exchange Act and is therefore invalid to that extent.

16/ 15 U.S.C. 78o-3(i).

There is nothing in the language itself of Rule 25(b)(2) to suggest that it was intended to restrict the flow of commissions in one direction only. At one point in its brief the Division concedes that the rule ". . . can be said to be unqualified, insofar as the direction of discounts is concerned . . . ." Accordingly, this would seem to call for application of the principle that where the language of a statute (or regulation) is plain and does not lead to absurd or wholly impractical consequences, it is the sole evidence of legislative intent.[17/] Moreover, Rule 25(b)(2) has consistently and frequently been applied from the time of its adoption and its approval by the Commission in 1939 as barring the flow of commissions in both directions. The Division and Aetna urge that at the time Rule 25(b)(2) was adopted the formation of underwriting syndicates was largely under the control of the nation's leading investment bankers, who were expected to form the core of the new self-regulating association (that became the NASD), and that the problem was to provide economic inducement to small broker-dealer firms to join by providing that association members could not give them underwriting discounts if they did not join the association. This is mere "lawyers argument" as the record establishes no such purpose or intention[18/] to limit the effect of Rule 25(b)(2) on the part of its drafters or of the Commission, which approved the rule.

17/ Caminetti v. United States, 242 U.S. 470 (1916); see also McKenzie v. Hare, 239 U.S. 299, 308 (1915). The NASD's rules, authorized by Section 15A of the Exchange Act and subject to pervasive oversight by the Commission, are quasi-legislative in character. Harwell, et al. v. Growth Programs, Inc., et al., unreported memorandum opinion, Judge Roberts (6-8-70), U.S.D.C., W.D. Tex., CCH Fed. Sec. L. Rep. §92,694, '69-'70 Decisions.

18/ Nor does the record satisfactorily establish the factual basis upon which the argument is premised.

The Division and Aetna argue alternatively, as already mentioned, that Rule 25(b)(2), if it in fact prohibits the flow of underwriting commissions both ways, is illegal as exceeding the statutory authority for issuance of the rule contained in Section 15A(i)(1)[19/] of the Exchange Act.

This argument involves an excursion into the New Deal era during and prior to the time the Maloney Act additions to the Exchange Act were enacted in 1938.

The National Industrial Recovery Act ("NIRA") enacted by Congress in 1933 authorized various industry groups to organize themselves into self-regulating bodies and to adopt codes of fair practice, subject to Presidential approval. The Investment Bankers Code, approved by President Roosevelt on March 23, 1934, was one of the "industrial codes" approved under the NIRA and it was also one of the codes that fell after the NIRA was struck down in the Schechter case.[20/]

The Investment Bankers Code included an express anti-joining provision in its trade-preference rules, contained in Article IX, Section 7. Paragraph (a) of Section 7 provided as follows:

> "Section 7. Registered Investment Bankers. --(a) No registered investment banker shall, in any transaction with any investment banker not registered under Article X hereof, allow or grant to such non-registered investment banker any allowance, commission, or discount usually and customarily to be allowed to another dealer; nor shall any registered investment banker join with any investment banker not registered under Article X hereof in any syndicate or group contemplating distribution to the public of any issue of securities; nor shall any registered investment banker sell any security to or

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19/ For text of the subsection see p. 15 above.

20/ Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

> buy any security from any investment banker not registered under Article X hereof, except at the same price at which at the time of such transaction such registered investment banker would buy or sell such security, as the case may be, from or to a person who is a member of the public not engaged in the investment banking business." (Emphasis added)

Following the invalidation of the Investment Bankers Code, investment bankers continued their efforts to organize a viable self-regulatory organization, mindful, however, of the problems that lack of a statutory exemption from the anti-trust laws presented. In October of 1935 the Investment Bankers Conference was organized, but this group's rules had to eschew any anti-joining feature because of the anti-trust laws. In September of 1936 investment bankers formed the Investment Bankers Conference, Inc. with considerable encouragement from the Commission. This group was formed in the expectation and hope that when Congressional sentiment favored such a move legislative authorization for an organization on a national scale with anti-trust exemption would be obtained. This industry group and the Commission and its staff worked in tandem [21] during the period 1936 through 1938 to achieve enactment of the Maloney Act. [22] This act, which added a new Section 15A to the Exchange Act, established statutory authorization for self-regulation by industry of the over-the-counter securities market subject to pervasive oversight by the Commission. Section 15A(i) authorized industry groups to adopt restrictive-dealing rules in terms that did not involve an express mention of the anti-joining provision or the other express provisions that had been contained in the

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21/ The record shows that after an initial draft by the Commission staff, the drafting of the act became a joint effort of the Commission and the industry group, involving numerous meetings and discussions at various levels. Presentation of the proposal to the Congress was also a joint effort.

22/ Act June 25, 1938, c. 677, 52 Stat. 1070.

1933 Investment Bankers Code. Instead, Section 15A(i) expressed the authorization for restrictive-dealing provisions in broad terminology providing that the rules of a registered securities association could legally provide that no member thereof may legally "deal with" any non-member except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by the member accorded to the general public.23/

At the outset it may be worthwhile to note that Section 15A(i) does not expressly refer to underwritings and that the language employed therein "except at the same prices * * * as are * * * accorded to the general public" might suggest non-applicability of the Section to the underwriting situation, in which the "general public" does not participate.24/ Nevertheless, it is clear that the section has been applied and is applicable to underwritings25/ and none of the parties contends otherwise.

The legislative history of Section 15A(i) contains no reliable answer to the disputed question whether its terms were intended to authorize the two-way restrictions contained in the NASD's Rule 25(b)(2) respecting underwritings. The few references to the Section that occur in the Maloney Act's legislative history are simply too general to be of any

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23/ For text of §15A(i) see p. 15 above.

24/ The Division urges that in the distribution process the issuer or selling stockholder is a member of the "general public" within the meaning of §15A(i) and that therefore Rule 25(b)(2) is invalid since NASD members are allowed to receive commissions from issuers and selling stockholders; the NASD on the other hand contends that the language "except at the same prices * * * as are * * * accorded to the general public" has no applicability to the underwriting situation and that Rule 25(b)(2) therefore properly is phrased in terms of a flat prohibition. It is concluded that the NASD's position is correct.

25/ Cf. In the Matter of National Securities Dealers, Inc., 19 SEC 424, 442 (1945) As already noted, the earlier Investment Bankers Code expressly covered the underwriting situation.

help. While Section 15A(i)(3) 26/ does refer to "granting" of discounts etc. by a member to non members and offers some small support to the position of the Division and Aetna it is not, standing alone, absent any real support in the legislative history, a sufficient basis for concluding that the broad and unrestricted terminology "deal with" in fact was intended to authorize restricting the flow of commissions, discounts, etc. in but one direction.

Fortunately, however, determination of whether §15A(i) indeed does authorize the two-way restrictions imposed by Rule 25(b)(2) is not dependent upon the meager and unilluminating legislative history. A reliable guide 27/ to the meaning and scope of Section 15A(i) in this respect is available from the long-standing administrative construction and application thereof.

Following passage of the Maloney Act the investment banker community, in close cooperation with the Commission, went about organizing itself into what was to become the NASD. An important aspect of this effort was formulation of the new organization's Rules of Fair Practice, in whose drafting the Commission collaborated and which were approved by the Commission in August, 1939. Rule 25(b) of those Rules followed quite closely similar provisions that had been included in the Investment Bankers Code. 28/

From the time it first issued its Rule 25(b)(2) the NASD has consistently (and frequently) applied its anti-joining provisions as barring the flow of underwriting commissions in both directions. The Division and

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26/ See p.15 above for text.

27/ II Sutherland, Statutory Construction, §5104, pp. 514-5(3d Ed.)

28/ See pp. 17-8 above.

Aetna do not contest this fact. The record herein establishes that early in the history of the rule its application to underwritings involving broker-dealers who were members of the New York Stock Exchange but non-members of the NASD arose. In numerous other instances the question arose in connection with the status of suspended members of the NASD, since during periods of suspension such broker-dealers had to be treated as non-members of the NASD under its rules. 29/ In thirty two disciplinary decisions the NASD has so applied Rule 25(b)(2). 30/ In addition, in response to numerous particular inquiries over the years the NASD has taken the same position it now urges.

Moreover, the NASD's application of its Rule 25(b)(2) as imposing a two-way restriction on the flow of commissions has been sanctioned by the acquiescence of the Commission, which is charged by statute with very extensive oversight functions. 31/ While the Commission has never heretofore had the question of the NASD's construction of Rule 25(b)(2) squarely before it, and while there is room to question whether all applications of the Rule came to the notice of the Commission itself, 32/ the applications

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29/ The NASD repeatedly advised its members via circulars and the like, including inserts for the NASD manual, of how the Rule was being applied.

30/ While these disciplinary actions involved other violations as well, they nevertheless did involve application of Rule 25(b)(2) and none of these cases was appealed to the Commission or taken up for review by the Commission on its own motion.

31/ Among the numerous powers of review conferred upon the Commission by Section 15A is the power under subsection (k)(1) thereof to abrogate any rule of an association in accordance with stated procedures and criteria.

32/ As an example, the Commission's liason officer with the NASD (a non-lawyer) analyzed and routed NASD disciplinary decisions to the Commission's regional administrators and staff, but there is no proof that Commissioners themselves had the actions brought to their notice.

were simply too numerous and continued over too extended a period of time to permit a conclusion that the Commission was unaware of such constructions and applications by the NASD.[33/] The Commission's language in its PSI decision[34/] suggests that it was well aware of the broad application of Rule 25(b)(2) by the NASD and that it concurred therein. At p. 441 the Commission stated:

> "As a result of this section [Section 15A(i)] it is virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of important size. Indeed, the rules of the NASD under the above statutory authority not only prohibit members from dealing with nonmember brokers and dealers as above provided, but also forbid members to 'join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or part thereof . . .' 27a/ [Citing Rule 25(b)(2) and the Commission's approval thereof] Since the major underwriting firms of the country are members of the NASD, nonmember firms are practically excluded from participating in this type of business . . . ."

In the same vein, then-Chairman Carey testified for the Commission as follows respecting Rule 25(b)(2) in the course of testimony on the Securities Act Amendments of 1964:[35/]

> "This overwhelming proportion [of the total number of broker-dealers being members of the NASD] is not surprising since— as an inducement to membership — Congress specifically permitted an association to prohibit a member from joining with a non-member in the distribution of securities or from giving discounts from retail prices to non-members."

33/ The Commission was on the "mailing list" for all NASD circulars and communications that went to the NASD membership at large; Regional Administrators of the Commission maintained close contacts with NASD representatives respecting NASD disciplinary and other matters and must have known how the NASD was applying the Rule; in addition to the liason officer specially appointed by the Commission, good liason between the Commission and the NASD existed at various levels at various times during the period involved, including the level of Commissioners. In addition, the "presumption of regularity" would call for a conclusion that the Commission properly carried out its statutory oversight functions over the long period here involved.

34/ In the Matter of National Association of Securities Dealers, Inc., 19 SEC 424, 441 (1945).

35/ Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, 88th Cong., 1st and 2nd Sess., Part 2, p. 1216 (1963-4).

Long-continued administrative application of a statute is well recognized as an aid to its construction. Thus, Sutherland states:[36/]

> "Contemporaneous and practical interpretation serves as another aid of statutory construction, and therefore, must be weighed against the other factors pertinent to the determination of legislative intent.
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> * * * *
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> "The conclusiveness of a contemporaneous and practical interpretation will depend upon a number of additional elements that give efficacy to the rule. In general, these elements are: (1) that the interpretation originated from a reliable source; (2) that the interpretation has continued for a long period of time and received wide acceptance; and (3) that the interpretation was made at or near the time of the enactment of the statute. Where these factors are present the vagueness usually surrounding the other aids of construction are not present, and therefore the rule serves as one of the most definite and reliable sources of statutory meaning."

In Midwest Oil the United States Supreme Court reviewed the historical background of the rule, stating as follows:[37/]

> "It may be argued that while these facts and rulings prove a usage they do not establish its validity. But government is a practical affair intended for practical men. Both officers, law-makers and citizens naturally adjust themselves to any long-continued action of the Executive Department--on the presumption that unauthorized acts would not have been allowed to be so often repeated as to crystalize into a regular practice. That presumption is not reasoning in a circle, but the basis of a wise and quieting rule that in determining the meaning of a statute or the existence of a power, weight shall be given to the usage itself -- even when the validity of the practice is the subject of investigation.
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> "This principle, recognized in every jurisdiction, was first applied by this court in the often cited case of Stuart v. Laird, 1 Cranch, 299, 309. There, answering the objection that the Act of 1789 was unconstitutional in so far as it gave Circuit power to Judges of the Supreme Court, it was said (1803) that, 'practice and acquiescence under it for a period of several years, commencing with the organization of the judicial system, affords an irresistible answer, and has indeed fixed the construction. It is a contemporary interpretation of of the most forcible nature. This practical exposition is too strong and obstinate to be shaken or controlled.'"

36/ II Sutherland, Statutory Construction, §5104, pp. 514-5 (3d Ed.)

37/ United States v. Midwest Oil Company, 236 U.S. 459, 472-73 (1915).

In the Norwegian Nitrogen Products case the Supreme Court stated: 38/

> ". . . True indeed it is that administrative practice does not avail to overcome a statute so plain in its commands as to leave nothing for construction. True it also is that administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. [Citing cases] The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new . . . ."

In utilizing this principle of statutory construction it is relevant to consider by what agency or body the statute has been construed and applied. On this point the Supreme Court has said: 39/

> ". . . In United States v. Moore, 95 U.S. 760, 763, this Court said: 'The construction given to a statute by those charged with the duty of executing it is always entitled to the most respectful consideration, and ought not to be overruled without cogent reasons . . . . The officers concerned are usually able men, and masters of the subject. Not infrequently they are the draftsmen of the laws they are afterwards called upon to interpret.'"

On the same point, Sutherland states: 40/

> "The practice and interpretative regulations by officers, administrative agencies, departmental heads and others officially charged with the duty of administering and enforcing a statute will carry great weight in determining the operation of a statute."

As to the length of time a particular interpretation has been applied, Sutherland states: 41/

> "Like all precedents, where contemporaneous and practical interpretation has stood unchallenged for a considerable length of time it will be regarded as of great importance in arriving at the proper construction of a statute. Thus contemporaneous interpretations of five, nine, ten, eighteen, twenty, twenty-five, fifty, fifty-six, sixty and seventy years have been permitted to govern legislative meaning.

38/ Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 315 (1933).

39/ Hastings & Dakota R. Co. v. Whitney, 132 U.S. 357, 366 .

40/ II Sutherland, Statutory Construction, §5105, p. 516 (3rd Ed.)

41/ II Sutherland, Statutory Construction, §5107, pp. 520-21 (3d Ed.).

> "[Citations omitted] One of the soundest reasons sustaining contemporaneous interpretations of long standing is the fact that reliance has been placed thereon by the public and those having an interest in the interpretation of the law."

In a leading case, Udall v. Tallman, the Supreme Court in 1964 applied the principle even though it said it may have disagreed with the implementation of the statutory authority if it had reviewed it in the first instance:[42]

> ". . . 'To sustain the Commission's application of this statutory term, we need not find that its construction is the only reasonable one, or even that it is a result we would have reached had the question arisen in the first instance in judicial proceedings.' [Citation omitted]"

In short, where the broad "deal with" language of Section 15A(i) is clearly comprehensive enough to accommodate Rule 25(b)(2), the administrative construction and application thereof as imposing a two-way bar on the flow of underwriting commissions and concessions, adopted and applied by the NASD as a quasi-regulatory agency and sanctioned by the acquiescence of the Commission as the agency charged with comprehensive oversight functions over a period of some 32 years, precludes a conclusion that Section 15A(i) does not afford legal authority for Rule 25(b)(2).

But arrival at this conclusion does not necessarily mean that the Commission may not abrogate Rule 25(b)(2), since the Commission does have statutory authority to abrogate legally-valid rules of the NASD if it finds the existence of factors meeting the criteria for abrogation set forth in §15A(k)(1) of the Exchange Act. But before turning to that question, there remain for determination various other questioned applications by the NASD of its Rule 25.

42/ Udall v. Tallman 380 U.S. 1, 16 (1964); See also cases cited therein.

As already noted above 43/ the NASD construes its Rule 25(a) and Rule 25(b)(2) as precluding "parallel underwriting", i.e. a situation in which an issuer would utilize dual but independently - operating principal underwriters, one of whom would be an NASD member with access to that channel for distribution and the other of whom would be a SECO-regulated broker-dealer able to distribute the issue through other SECO-regulated broker-dealers. 44/

While question No. 5 of the numbered questions serving to frame generally the issues herein is put in terms of parallel distribution of mutual funds or variable annuities, it is clear that from a legal standpoint the propriety or lack of it of the NASD's construction of its Rule 25 as precluding parallel distributions does not turn upon whether the issue of securities is one of mutual fund shares or variable annuities or a more traditional security.

However, it may be that parallel underwritings are more suitable to mutual fund and variable annuity distributions than they are to distributions of more traditional issues. The underwriting process, involving the public distribution of a security, is considerably different for a variable annuity or a mutual fund than it is for the "traditional" security. There is no fixed number of shares to distribute. There is no formation of syndicates which stand to suffer financial losses if the distribution gets slow or "sticky". The technique of "stabilization" is not employed. The danger of bids and purchases by one engaged in the distribution is not a factor. Because of these differences it is somewhat easier to visualize bona fide parallel distributions of mutual funds

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43/ Pages 10-11.

44/ See discussion above at p.10 of the various forms such arrangements could take. It is understood that in no case will the separate underwriters have any common staff or facilities.

or variable annuities than of the more traditional issues but, assuming, the genuineness of the parallel underwriting (i.e. that the underwriters are in fact not dealing with or joining one another) both types of parallel distributions should be equally allowable or not allowable under the NASD's Rule 25.

The NASD urges that notwithstanding the legal and factual independence of the two principal underwriters, they are still "dealing with" one another within the meaning of Section 15A(i) and "joining with" one another within the meaning of Rule 25(a) and Rule 25(b)(2). It takes this position as to all forms of parallel underwriting, i.e. without regard to whether the issuer is affiliated with one or both underwriters or not.

There is no support for this position. Under the conditions hypothesized, the two principal underwriters do not "deal with" one another in any meaningful sense, either directly or through any third person. Neither of them is receiving or granting any commissions or concessions to or from the other, nor are they splitting commissions or concessions generated by any common effort. One can fail miserably in his efforts without necessarily affecting the success of the other. The language "join with" in the Rule cannot be more comprehensive in this respect than the language "deal with" in the statute, since the former depends upon the latter for its statutory authority. The term "join with", as the words themselves suggest, must include some element of joint effort rather than two independent efforts that merely happen to be simulantaneously occurring.

This result is clearest in the situation in which the issuer is unaffiliated with either principal underwriter. But even where there is an affiliation between the issuer and one, or both, of the underwriters,

there is no need, insofar as application of Rule 25 is concerned, for going beyond the separate legal identities of the two underwriters. While the NASD's rules properly control what its members do, they have no competence to control the activities of persons who happen to have an ownership interest in a member. Here the NASD is telling the issuer what he may not do -- i.e. utilize two channels of distribution -- and not controlling merely its NASD member, as it purports to be doing. There is no occasion for "piercing the corporate veil" here where there is no purpose to defraud or circumvent but only an above-board desire to do business in both of two separate channels. The question is not who owns the two parallel underwriters but whether they are dealing with one another, and this they clearly are not doing.

Accordingly, it must be concluded that the NASD's construction of its Rule 25 as forbidding parallel distribution is erroneous and contrary to law.[45/]

There remains for consideration the NASD's interpretation and application of its Rule 25 as barring an insurance-brokerage firm from establishing two independent broker-dealer subsidiaries, one a member of the NASD and the other SECO regulated, for the handling of investment-company securities. Here again, there is no foundation for the NASD's application of Rule 25 to this situation, since it results in no "dealing" between the two independent subsidiaries and no "joining" of one with the other. There is not involved any "evasion" of the NASD's rules -- each broker-dealer entity merely operates within its authorized area.

45/ Unlike its construction of its Rule 25(b)(2) as barring the two-way flow of commissions, the NASD's construction of Rule 25 as barring parallel underwritings is not supported by the authorizing legislation. Since this conclusion involves a misapplication of the rule, no question of abrogation is presented as to it.

The fact that the two entities are commonly owned does not change this reality in any sense that is here relevant. This application of its Rule 25, too, is erroneous and unauthorized, and therefore contrary to law.[46/]

The suggested arrangement for "dual registration", whereby an NASD-member broker-dealer would have within it one or more individual registered representatives who are associated persons of a SECO-regulated broker-dealer, calls for a different conclusion. Here it may fairly be said that there is a "dealing with" or "joining with."[47/]

Returning now to the NASD's (valid) application of its Rule 25(b)(2) as barring the flow of commissions or concessions in both directions, there remains for decision the question whether such rule as applied to underwritings of mutual funds and variable annuities[48/] should nevertheless be abrogated by the Commission in whole or in part under the criteria specified by Section 15A(k)(1)[49/] of the Exchange Act, which reads:

> "(k)(1) The Commission is authorized by order to abrogate any rule of a registered securities association, if after appropriate notice and opportunity for hearing, it appears to

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46/ Since this determination involves only a misapplication of Rule 25, no question as to abrogation of the Rule is presented thereby.

47/ Moreover, as a practical matter, the NASD should be able to control what goes on within its member firms in personnel terms, and arrangements such as this could complicate the process of self-regulation.

48/ Consideration is limited to underwritings involving mutual funds and variable annuities because the six questions utilized to frame the issues in this proceeding were put in those terms and because the evidence in this record does not go beyond those classes of securities in suggesting a need for remedial action.

49/ 15 U.S.C. 78o-3(k)(1).

> the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this title." (Emphasis added).

The relevant "purposes" of the Exchange Act bearing on the Commission's authority to abrogate the NASD's rules are stated in Section 15A(b)(8) [50/] of the Exchange Act, which provides:

> "(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that —
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> * * * *
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> (8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers, or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." (Emphasis added).

As already concluded above, the record shows unmistakeably that the economic harm to Aetna flowing from the application of Rule 25 is both real and substantial. Moreover, the detriment is not confined to Aetna but extends also to the employers and their employees, who are denied opportunity to choose from the full range of equity products that would otherwise be available, and to insurance-brokerage firms, which are precluded [51/] from handling the full range of products of some of its

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50/ 15 U.S.C. 78o-3(b)(8).

51/ The option of forming two separate broker-dealer subsidiaries, one NASD and one SECO, treated elsewhere herein, is not always economically feasible.

insurance suppliers, such as Aetna. Since the employee-benefit avenue offers the most practicable and likely means for the workingman to obtain an equity interest in the economy any impediments to its full utilization are undesirable from the standpoint of public policy.

The parties are in sharp disagreement concerning the role that antitrust policy considerations ought to play here in the Commission's determination whether abrogation of Rule 25(b)(2) is necessary or appropriate.

Aetna urges that antitrust considerations reflected in the antitrust statutes must be considered in applying the standards set forth in Section 15A(k)(1) and Section 15A(b)(8), based in part upon the Silver case,[52/] which appears to suggest that the availability of regulatory review may be essential to antitrust immunity and that there should generally be a reconciliation of securities and antitrust law rather than an ouster of one by the other, with the antitrust exemption being implied only to the minimum extent necessary to make the Exchange Act work. Aetna also relies on Thill Securities Corp. v. New York Stock Exchange.[53/] In that case the Court of Appeals ruled that even though the rules of an exchange are subject to the Commission's oversight, courts may still review under antitrust standards to test whether the rule is necessary for the operation of the Exchange Act.[54/] Aetna also cites decisions emanating from regulated industries other than the securities business in which courts have held it necessary to weigh antitrust considerations in determining the public interest.[55/]

52/ Silver v. New York Stock Exchange, 373 U.S. 341, 364 (1963).

53/ CCH, Fed. Sec. L. Rep., '69-'70 Decisions, Par. 92756 (C.A. 7th, 1970).

54/ The question of whether primary jurisdiction for application of such standards lies with the Commission was left somewhat cloudy by the various opinions of the court.

55/ Municipal Electric Assoc. of Mass. v. SEC, 413 F.2d 1052 (C.A.D.C. Cir., 1969); Northern Natural Gas Co. v. FPC, 399 F.2d 953 (C.A.D.C. Cir., 1968).

In addition Aetna quotes the statement of former Commission Chairman Cohen in a letter of July 30, 1965, to the Chairman of the Senate Committee on Banking and Currency with reference to Section 15A(b)(8): ". . . the rules of [national securities] associations must be designed not only to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade but also to effectuate policies related to the antitrust laws."

And lastly, Aetna cites the Commission's decision in the PSI case,[56/] where it was said that application of the Sherman Act had been "properly raised as a problem to be considered" in determining whether the NASD had properly interpreted Section 1 of its Rules by imposing sanctions against members who had violated price-maintenance provisions of underwriting and selling agreements.

The NASD contends, on the other hand, that since Section 15A(n)[57/] of the Exchange Act affords an exemption from the antitrust statutes, antitrust policy has no place in this proceeding and that the only question is whether the rule sought to be abrogated conforms with the requirements of the Maloney Act.

While Section 15A(n) does indeed afford an exemption from the antitrust statutes,[58/] the fact is that Congress at the same time built into Section 15A various standards that are anti-monopolistic and anti-trust in character. Thus, Section 15A(b)(8) provides that the rules of a registered securities

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56/ In the Matter of National Association of Securities Dealers, Inc., 19 SEC 424, 436 (1945).

57/ 15 U.S.C. 78o-3(n). The language reads: "(n) If any provision of this section is in conflict with any provision of any law of the United States in force on June 25, 1938, the provision of this section shall prevail."

58/ United States v. Morgan, 118 F. Supp. 621, 693 (S.D.N.Y. 1953).

association shall "remove impediments to and perfect the mechanism of a free and open market", and "protect investors and the public interest." This objective of a "free and open market" and the generally anti-monopolistic thrust of §15A(b)(8) is inevitably to some degree at war with Section 15A(n) and the authority conferred in the same (Maloney) Act to registered national securities associations to adopt restrictive-dealing rules (Section 15A(i), set forth above at p. 15). Congress was able to build such internal contradiction or "dynamic tension" into the Act only because it concurrently gave the Commission sweeping oversight authority that enables it to harmonize the antitrust or antimonopoly objectives of the Act with the necessity of making its scheme for self-regulation work effectively through restrictive-dealing rules and other appropriate means.[59/]

This process of "harmonizing" the opposing Congressional desiderata involves a nice balancing of competing factors, equities and requirements by the Commission.

Since the tendency of the NASD's Rule 25(b)(2) is to impair or conflict with the objectives of a "free and open market" and the protection of "investors and the public interest,"[60/] as those terms are employed in Section 15A(b)(8), for reasons found above, it is unnecessary to consider here to what extent antitrust statutes or principles outside the Exchange Act may be applicable. The objectives of a free and open market and the protection of investors and the public interest are both objectives that are clearly broad enough to embrace the purpose here sought to be realized, i.e. affording reasonable access for a large segment of the public to

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59/ See Silver v. New York Stock Exchange, 373 U.S. 341 (1963), particularly at p. 358).

60/ Protection of investors includes protection of their right to reasonable access to sellers.

equity products (mutual funds and variable annuities) via group sales within the employee-benefit context. Put another way, Section 15A(b)(8) itself contains all of the "anti-trust" standards that are necessary to a decision in this proceeding.

There remains for consideration the question whether abrogation of Rule 25(b)(2) would materially and detrimentally affect the revenues of the NASD and seriously diminish its regulatory capability, as it contends. This is a factor that the Commission must weigh carefully, of course, in deciding whether abrogation is warranted.

In this connection it must first be concluded that this record and the findings made herein would not support more than a partial revocation of Rule 25(b)(2), i.e. the feature or aspect thereof that precludes NASD-member broker-dealers that are subsidiaries of insurance-brokerage firms from handling group sales of mutual funds and variable annuities that are underwritten by principal underwriters that are SECO regulated. The record does not establish any public interest need for abrogation of the rule generally as to all classes of securities or generally as to all broker-dealers. The relief that the above-stated partial revocation would afford would have the practical benefit of permitting an insurance broker to handle his group sales of investment-company securities through one (NASD member) broker-dealer subsidiary, rather than requiring him to form and operate two separate broker-dealer subsidiaries, one an NASD member and the other SECO regulated.

The evidence in this record indicates that the partial revocation described above would have minimal impact on the NASD's revenues and its ability to function effectively. While some insurance-oriented principal

underwriters might withdraw from the NASD and opt for SECO regulation, there is no indication that the number of withdrawals would be large enough to have any seriously detrimental effect on the NASD. Insurance-brokerage firms with NASD broker-dealers affiliates would keep them in the NASD because such affiliates are able to handle many more equity products than they would be able to do as SECO-regulated broker-dealers. This is so because Rule 25(a) [61/] of the NASD's rules prohibits its members from paying commissions to nonmembers, and the big majority of principal underwriters are NASD members. At the same time, under a partial revocation of Rule 25(b)(2), NASD-member subsidiaries would be able to handle certain SECO-underwritten equity products as well. The same considerations that would favor keeping an NASD-member subsidiary broker-dealer in the NASD would also favor making new subsidiaries members thereof.

In addition, other factors would favor retaining or obtaining NASD membership as against becoming SECO regulated. These include such affirmative advantages as enjoying the benefits of NASDAQ and other innovations sponsored by the NASD and the natural predisposition of most broker-dealers to prefer self-regulation through a voluntary association to regulation by a governmental agency. Also, since the Commission took over regulation of the SECO broker-dealers reluctantly and only because the Congress so directed in 1964, it may be presumed that the Commission will so fix registration and licensing and other charges for the SECO group as not to give an economic advantage to SECO membership from that standpoint.

61/ See p. 13 above for text of the rule.

Finally, in the event that partial abrogation of Rule 25(b)(2) were to have materially adverse effects upon the NASD on the basis of circumstances that are not apparent in this record, the Commission would have ample authority to remedy the situation.

Apart from its (unfounded) contention as to potential membership loss, the NASD urges that if it were through abrogation of Rule 25(b)(2) required to permit its members to distribute SECO underwritten mutual funds and variable annuities the public interest would suffer because the NASD would not have control of all phases of the distribution. A number of considerations make this argument untenable. Firstly, it must be assumed that the Commission will satisfactorily regulate the SECO principal underwriter. Secondly, the NASD would fully be able to control the activities of its members to assure against improprieties. Thirdly, because of the special character of distribution of open-end investment-company securities, discussed above,[62/] unified regulatory control of all aspects of a distribution is of less importance than it would be in a distribution of a "traditional" issue. Lastly, it is noteworthy that the NASD has itself allowed certain exceptions to its rule.[63/]

Accordingly, it is concluded that under the criteria established by Section 15A(k)(i) and Section 15A(b)(8) of the Exchange Act partial[64/]

62/ See pp. 26-7 above.

63/ In 1969 the NASD took a "no-action" position with respect to the distribution of defined classes of group variable annuity contracts which certain of its members sponsored and desired to distribute through nonmembers. At least one member is still operating under this informal exemption. The grant of this exemption smacks more of expediency than of a well-founded basis for differentiation and it therefore weakens the NASD's claim that Rule 25(b)(2) must be kept inviolate.

64/ The power to do the greater act, i.e. complete abrogation of Rule 25(b)(2), includes the power to do the lesser, i.e. requiring the NASD to partially "revoke" the rule by carving out an exception thereto. Cf. Shearson, Hammil & Co., Securities Exchange Act Release No. 7743, November 12, 1965, at p. 38.

abrogation of Rule 25(b)(2) of the NASD's rules is necessary and appropriate, together with the other forms of relief afforded herein.

Conclusions

In general summary of the foregoing, the following conclusions are reached:

(1) Rule 25(b)(2) of the NASD's Rules of Fair Practice forbids the receiving of commissions, discounts, allowances and the like by NASD members as well as the giving of such commissions etc. by such members. In so providing, the Rule is a valid exercise of the NASD's authority under Section 15A(i) of the Exchange Act. Therefore the NASD's responses in the negative to questions numbered 1 and 2 of the numbered questions framing the issues herein are legally justified.

(2) Notwithstanding the conclusions in the next preceeding paragraph, the record in this proceeding establishes that under the revocation criteria set forth in §15A(k)(1) and §15A(b)(8) of the Exchange Act a limited revocation of Rule 25(b)(2), taking the form of an exception thereto permitting NASD-member affiliates of insurance-brokerage firms to join in distributions involving group sales of mutual funds and variable annuities whose principal underwriters are SECO regulated, is necessary and appropriate.

(3) The NASD's construction and application of its Rule 25 as precluding participation by its members as principal underwriters in parallel distributions is not legally justified under its Rule 25 or Section 15A(i) of the Exchange Act inasmuch as such parallel distributions involve no "dealing with" or "joining with" the nonmember. The NASD's construction and

application of its Rule 25 as barring formation by an insurance-brokerage firm of two separate broker-dealer subsidiaries, one an NASD member and the other SECO regulated, is likewise not legally justified.

(4) The NASD's response in the negative to question No. 4 of the questions framing the issues herein is legally and practically justified.

ORDER

In accordance with the foregoing findings,[65/] conclusions and reasoning,

IT IS ORDERED as follows:

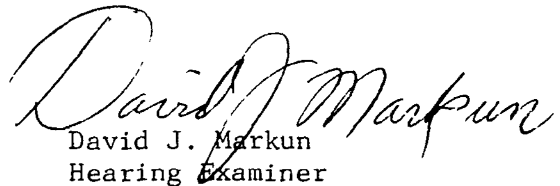
A. Section 25(b)(2) of Article III of the Rules of Fair Practice of the respondent, the National Association of Securities Dealers, Inc., is hereby abrogated effective 60 days from the effective date of this initial decision: Provided, however, that this provision shall be null and void if respondent shall have before expiration of such 60 day period duly promulgated an exception to such rule consonant with conclusion (2) stated above.

B. Respondent shall cease construing and applying Section 25 of its Rules of Fair Practice in contravention of the conclusions stated in paragraph (3) above and shall, within 60 days of the effective date of this initial decision, advise all its members by usual and appropriate means of such changes in interpretation and application of the rule.

65/ The usual standard of preponderance of the evidence has been followed in making findings herein. Findings and conclusions are based upon the record and upon observation of the various witnesses. To the extent that the proposed findings and conclusions submitted by the parties are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the issues presented.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen (15) days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



David J. Markun
Hearing Examiner

Washington, D.C.
May 28, 1971