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U.S. SECURITIES AND EXCHANGE COMMISSION

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PART I

IMPORTANT RECENT DEVELOPMENTS

Special Study of Securities Markets and its Implementation

Fiscal year 1964, which marked the 30th year of the Commission's existence, and the months that followed was a period of extraordinary, even historic, significance for the Commission, the parts of the nation's economy which are concerned with the issuance and trading of securities, and, of course, public investors.

Shortly after the beginning of the year, the final two portions of the Report of the Special Study of Securities Markets were transmitted to Congress.[1] The Special Study and the Report, constituting the most thorough examination of the securities markets since the early 1930's, have already had far-reaching consequences. Even while the study was still in progress, it stimulated an extensive self-examination by various segments of the securities industry, most notably the self-regulatory agencies, which resulted in a number of improvements in the rules and practices of those agencies. Secondly, the Report provided a foundation for the far-reaching legislative proposals submitted by the Commission to Congress in June 1963, which, with certain modifications, were enacted into law in August 1964. This legislation (the "Securities Acts Amendments of 1964") is summarized in Part II of this Report and referred to at appropriate points elsewhere in the Report.[2]

The 1964 Amendments represent the most significant statutory advance in Federal securities regulation and investor protection since 1940. In the main, they eliminate the differences in reporting requirements between issuers of securities listed on the exchanges and the larger issuers whose securities are traded over the counter, allow the self-regulatory agencies and the Commission to raise standards for

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[1] For a summary of the contents of the Report, see the 29th Annual Report, pp. 1–3. The Report is available from the Superintendent of Documents, Government Printing Office, Washington, D.C., 20402, as H. Doc. No. 95 of the 88th Cong., 1st Sess. Pt. I: $2.25, Pt. II: $3.50, Pt. III: 50 cents, Pt. IV: $3.75. The letters of transmittal and the Study's conclusions and specific recommendations are set forth in a summary volume, Pt. V: 55 cents.

[2] A more extended summary and discussion of the legislation is contained in Securities Act Release No. 4725 (September 15, 1964).

ıtry into the securities business, and strengthen the Commission in ealing with broker-dealers and their employees. The legislation as strongly supported in principle by representatives of the securities ıdustry and by others affected by it, and it benefited from extensive ɜarings by the Congress which permitted a thorough consideration f all of the issues involved. In signing the measure, the President ated: "The law signed today should further strengthen the securities ıarkets and public confidence in them. Industry and government ıve worked together in the writing of these laws. Industry and ɔvernment will work together in making these measures succeed."

A number of changes in the Commission's rules have already been fected or proposed to implement the new legislation or to conform ıe rules to it. One important area still to be implemented relates ɔ the Commission's new authority to prescribe qualification standards ıd standards of conduct for those registered broker-dealers who are ɔt members of a registered securities association. The Commission now gathering more precise and fuller information as to the persons ıd firms affected and assessing the regulatory needs and problems hich may be anticipated.

Significant progress has been made in the way of administrative ɛtion by the Commission and the self-regulatory agencies in imple- ıenting the recommendations of the Special Study Report. This is, f course, a continuing process, and what is referred to herein as rospective action may well be accomplished fact by the time this eport appears in print. In one of the principal areas also dealt ith in the Amendments, qualification standards applicable to mem- ɔrs and their employees have been tightened by the self-regulatory gencies. Proposed amendments to the Commission's net capital rule ıtablishing for the first time a minimum net capital for broker-dealers ere submitted to the industry on an informal basis for comments; ɔmments have now been received and the proposal will be considered ɣ the Commission before it is officially published for comment.

The Commission's staff has devoted considerable effort to assisting ıe self-regulatory groups in the formulation of effective rules gov- ning selling practices. Primary emphasis was placed on supervision f salesmen by the principals of broker-dealer firms. The New York tock Exchange (NYSE) adopted a new supervision rule in the ɔring of 1964. The Board of Governors of the National Association f Securities Dealers, Inc. (NASD) has approved a package of rules hich set out in detail members' responsibilities for supervision, aintenance of certain records and handling of discretionary accounts. s of October 1964, these rules were submitted to the NASD member- ıip for adoption. At the same time increased attention is being paid

by the self-regulatory agencies to inspections of brokerage firms and enforcement of selling practice rules. The NYSE, American, and several regional exchanges have adopted new rules and interpretations with respect to advertising and investment advice. The NASD Board of Governors has adopted a comprehensive interpretation with respect to these matters. And the Commission's staff has drafted comparable rules applicable to investment advisers which will be submitted informally to the industry for comment in the very near future.

Two of the areas which were studied in great depth by the Special Study and were subjects in its Report of recommendations for extensive changes were the activities and responsibilities of floor traders and specialists on the exchanges. These recommendations in turn gave rise to extended discussions between members of the staff and of the New York and American stock exchanges, culminating in the adoption, on June 2, 1964, of Rule 11a–1 under the Exchange Act,[3] the first Commission rule ever adopted relating to floor trading, and the announcement, on September 24, 1964, of proposed Rule 11b–1 relating to specialists.[4] Briefly, the purpose of Rule 11a–1 is to eliminate the abuses which the Commission found in floor trading on the two major exchanges. The new provisions require that traders must have substantial capital and they are subjected to high performance standards, various conditions designed to eliminate or minimize possible conflicts with public customers, and other restrictions intended to channel their trading for beneficial purposes.[5] Upon the effectiveness of the rule, about 30 traders became registered on the NYSE, as compared with an estimated 300 persons who engaged in floor trading in recent years.

The proposed specialist rule, which also applies only to the two large New York exchanges, forms an integrated regulatory program together with rules which have been adopted by those exchanges and which will take effect concurrently with the effectiveness of Rule 11b–1. It contains three major parts. The first part would require the exchanges to have adequate rules in certain areas. Thus, for the first time the exchange rules would have to impose an affirmative obligation on specialists to utilize their capital as dealers to assist in the maintenance of a fair and orderly market, and the proposed exchange rules so provide. Additionally each exchange would have to establish adequate minimum capital amounts for specialists and provide effective methods of surveillance of specialist activities. Finally, the ex-

[3] Securities Exchange Act Release No. 7330.
[4] Securities Exchange Act Release No. 7432.
[5] For further discussion of this rule, see p. 13, *infra*.

ıges would be required to have rules on the brokerage responsibili-
s of specialists. Among the changes adopted by the exchanges are
es designed to assure that specialists' brokerage customers receive
best possible prices available and that the specialist does not give
ıself preferential treatment over his own customers. The second
t of Rule 11b–1 would establish a procedure by which the Commis-
ı can review and disapprove new exchange rules relating to special-
s if the Commission finds that they are inadequate to achieve the
poses described in the rule or are inconsistent with the public
erest or the protection of investors. The Commission, of
ırse, would retain the authority contained in Section 11 of the Ex-
ıge Act to adopt its own rules regulating the conduct of specialists
hat becomes necessary. The third part of Rule 11b–1 would permit
Commission to commence proceedings directly against a specialist
ertain cases where an exchange has failed to do so or its action has
n inadequate.

urning to the over-the-counter markets, a new Rule 15c2–7 re-
res dealers entering quotations in a system such as the "sheets" of
National Quotation Bureau to disclose whether they are acting
orrespondents, or have entered into some other financial arrange-
ıts with other dealers, and the identity of the latter. This informa-
ı is to be revealed in the published quotations by symbol, number
otherwise. The rule should improve significantly the reliability of
wholesale quotations system and make it more informative.[6] Ex-
sive consideration is also being given by the Commission and the
SD to revisions of the retail quotations system.

During the 1964 fiscal year, the Commission established an Office of
gulation within its Division of Trading and Markets, one of whose
mary responsibilities is to oversee the operations of the self-regula-
y agencies. In pursuit of that goal, the Office has conducted con-
ıing inspections of various operations of the exchanges and the
SD. Furthermore, the new Rule 17a–8, requiring the exchanges
ile with the Commission reports of newly proposed rules, enables
Commission to be aware, on a continuing basis, of developments in
exchange's policies and to offer the exchange, at an early point, the
efit of its views.[7] Important steps have also been taken by the
-regulatory agencies, particularly the NASD, to effect organiza-
ıal changes in line with the views expressed in the Special Study
port.

he above are only some of the many steps already taken or under
ive consideration as a result of the Special Study and its Report.

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[6] For further discussion of this rule, see p. 16, *infra*.
[7] This rule is discussed on p. 19, *infra*.

Enforcement Activity: Proposed Revision of Annual Report Form for Investment Companies

Although the Commission's attention during the 1964 fiscal year was focused to a considerable extent on the implementation of the Special Study's recommendations, its day-to-day enforcement activities, designed to combat fraudulent and other illegal practices in securities transactions, continued at a vigorous level. Details regarding the various aspects of these activities will be found in the appropriate parts of this Report. Among other things, 50 cases were referred to the Department of Justice for criminal prosecution during the year. On the civil side, 84 injunctive and related enforcement proceedings were instituted by the Commission in the Federal courts. And 458 investigations of securities transactions involving possible violations of the anti-fraud or other provisions of the securities acts were instituted. A substantial number of formal administrative proceedings were instituted with respect to broker-dealers and investment advisers—119 broker-dealer proceedings and 9 investment adviser proceedings.

The Commission's inspection program under the Investment Company Act of 1940, which has proceeded at a steadily accelerating pace since its inception in 1957, resulted in a record total of 146 inspections during the 1964 fiscal year. Even at that rate, however, each of the 617 so-called "active" registered investment companies would be inspected only once every 4.2 years. To place the inspection program even on a 3-year cycle would require additional personnel and entail other related expenses. It also takes time and expense to train inspectors, many of whom must necessarily be new recruits, to achieve a high degree of proficiency. The Commission has proposed expansion of its inspection program because of its proven value.

Even under an expanded inspection program, certain investment companies inevitably require closer or prompter scrutiny. Because of this and the continued growth in the number and size of investment companies, the Commission considered that the public interest and the protection of investors would be served by strengthening the annual report filed by investment companies, and accordingly it published a proposal, shortly after the end of the fiscal year, to revise the present Form N–30A–1, which is the current annual reporting form for all registered management investment companies except those which issue periodic payment plan certificates and small business investment companies licensed as such under the Small Business Investment Act of 1958.[8]

[8] Investment Company Act Release No. 4026 (August 4, 1964).

The proposed form, which emerged from some 2 years of drafting ıd redrafting by the staff, with the benefit of discussions and cor-spondence with committees representing the investment company dustry and the accounting profession, is designed to provide better sclosure to the investing public and to channel more effectively the ommission's inspection program. The form, either as published for ımment or as it may be modified prior to adoption, should also serve focus attention of the investment companies and their management ore sharply on the prohibitions and requirements of the Investment ompany Act and thus provide a significant measure of self-regula-on.

egistration of New Security Offerings

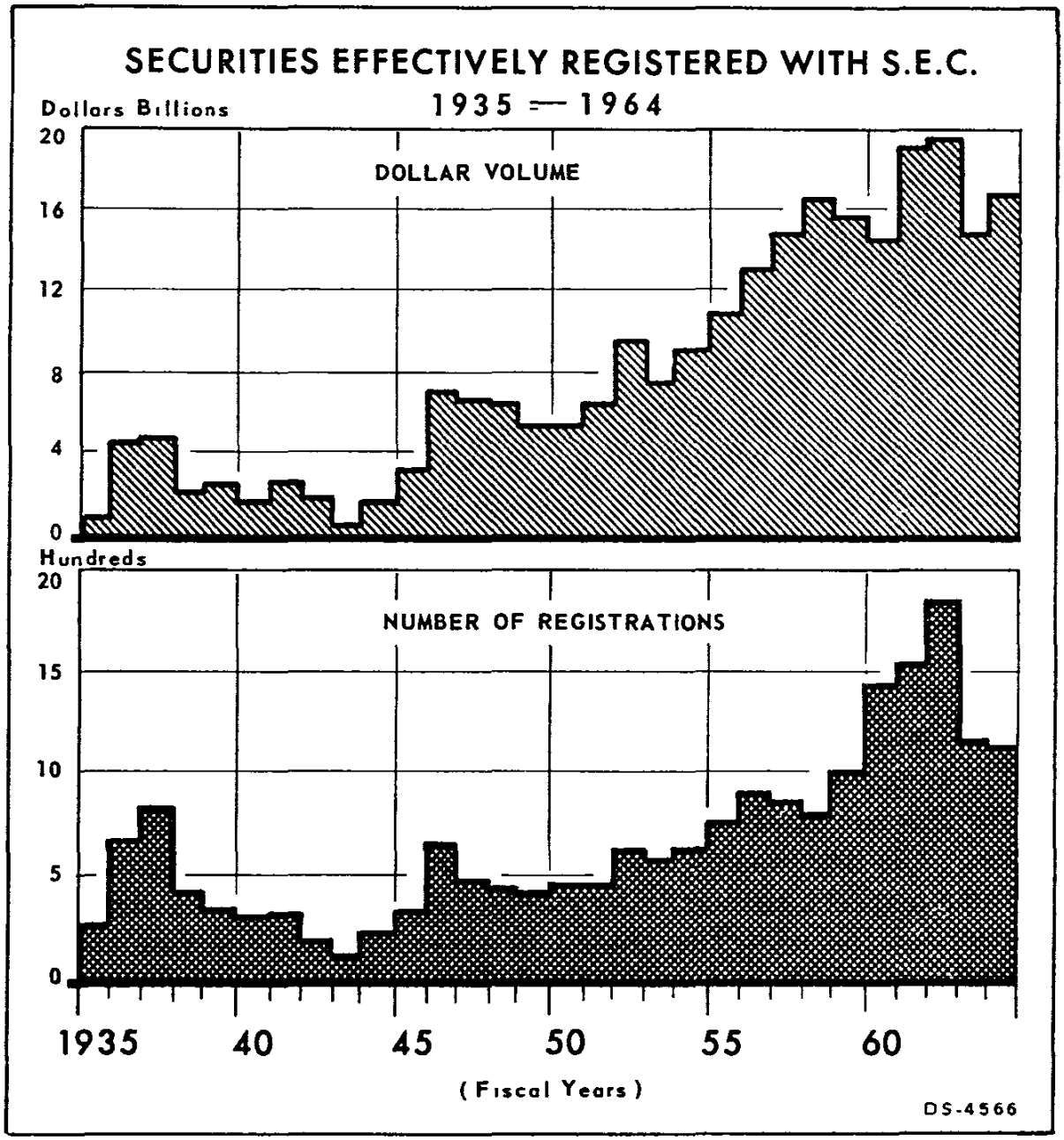
The 1964 fiscal year saw a slight increase over the previous year in .e number of registration statements filed, but a substantial increase the dollar amount involved. A total of 1,192 statements was filed ıring the year for securities with an aggregate offering price of $18.6 llion, as compared to 1,159 statements and $14.7 billion the preceding ear.

In the course of the fiscal year, the Commission published an exten-ve guide containing numerous policies and practices of its Division Corporation Finance with respect to the disclosures required by the ecurities Act of 1933 and the rules thereunder in connection with the ing of registration statements under the Act.[9] It is expected that the ıblication of these policies and practices will not only be of assistance registrants and their counsel and accountants in the preparation registration statements, but also that it will relieve the staff of the ommission of the necessity for commenting on these matters in re-ect of such statements.

The Commission and its staff are constantly striving to reduce the me required to process registration statements, without, of course, minishing the thoroughness of the examination procedure. During .e year, there was a further significant reduction. Thus, with respect registration statements which became effective during the year (ex-uding certain investment company filings), the median number of ays elapsing from the date of filing to the date of the staff's letter of ımment was 16, as compared with 27 the previous year; and the edian time from filing to effective date was 36 days as compared to 52 ays the year before. A total of 1,121 statements in the amount of

[9] Securities Act Release No 4666 (February 7, 1964).

$16.9 billion became effective during the year. The chart below portrays the dollar volume and number of registrations with respect to securities which became registered during the fiscal years 1935 through 1964.



PART II

LEGISLATIVE ACTIVITIES

During the fiscal year 1964, Congressional hearings were completed on the Commission's proposals for amendment of the Federal securities laws. Hearings had previously been held in the United States Senate before a Subcommittee of the Committee on Banking and Currency, immediately prior to the close of the fiscal year 1963, and during those hearings the broad purposes of the legislation were strongly endorsed by all segments of the securities industry. S. 1642, the Senate bill embodying the Commission's proposals, was passed by the Senate on July 30, 1963 and referred to the House of Representatives. A Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, held hearings for a total of 13 days on S. 1642 and two companion bills, H.R. 6789 and H.R. 6793.[1] After the close of the fiscal year, S. 1642 was passed by the House with certain amendments agreed to by the Senate, and was enacted as Public Law 88–467 on August 20, 1964. With some exceptions, the legislation as enacted was closely similar to the Commission's original proposals.

The Commission's legislative proposals were based upon the Report of the Special Study of Securities Markets[2] and had two major purposes. The first was to improve investor protections in the over-the-counter markets, primarily by extending to investors in a significant portion of the securities traded in those markets the fundamental protections which had been afforded generally only to investors in securities listed on a national securities exchange. Under the legislation as proposed by the Commission, the registration, periodic reporting, proxy solicitation and insider reporting and trading provisions of the Securities Exchange Act of 1934 were to be extended to over-the-counter companies having more than 750 shareholders (500 share-

[1] These identical bills had been introduced on June 4, 1963. S. 1642 was introduced (by request) by Senator A. Willis Robertson, Chairman of the Senate Committee on Banking and Currency; H.R. 6789 was introduced by Representative Oren Harris, Chairman of the Committee on Interstate and Foreign Commerce, House of Representatives; H.R. 6793 was introduced by Representative Harley O. Staggers, Chairman of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives.

[2] For a summary of the Report of the Special Study of Securities Markets, see the Commission's 29th Annual Report, pp. 1–3.

holders at a subsequent date) and more than $1,000,000 in assets. Companies meeting these standards would be required to file a registration statement containing material information regarding their businesses and to keep such information current by periodic reports; security holders whose proxies are solicited would be furnished with a proxy statement containing adequate and accurate information; and corporate "insiders" would be required to report their transactions in the securities of such companies and would be liable for short-swing trading profits in the securities of their company. Certain classes of companies were exempted from these requirements. The Commission's proposals in this area were embodied in Public Law 88–467, but were modified by the Congress to exempt also insurance companies which meet certain specified requirements.

The second purpose of the Commission's proposals was to strengthen the qualification standards for entrance into the securities business and to make more effective the disciplinary controls of the Commission and the rules of industry self-regulatory organizations over securities brokers and dealers and persons associated with them. Under the Commission's proposals registered securities associations were to be required to adopt rules, subject to Commission approval, establishing standards of training, experience and competence for members and their employees and to establish capital requirements for members. In addition, all over-the-counter broker-dealers would have been required to be members of a registered securities association in order to bring them within the self-regulatory scheme. Public Law 88–467 did not embody the latter proposal, but provides instead that if a broker-dealer is not a member of a registered securities association, the broker-dealer and all natural persons associated with the broker-dealer must meet such specified and appropriate standards with respect to training, experience and such other qualifications as the Commission finds necessary or desirable. Public Law 88–467 includes the Commission's other proposals in this area, including modification of the statutory scheme for disciplining violators so as to permit action directly against an individual; provision for the imposition of intermediate sanctions against a broker-dealer, such as temporary suspension or censure; and clarification of the authority of a national securities association to act directly against offending individuals.

In connection with Congressional consideration of the Commission's legislative proposals, members of the Commission testified before a Subcommittee of the House Committee on Interstate and Foreign Commerce on November 19 and 20, 1963 and on February 18 and 19, 1964. In addition Chairman Cary testified on March 5, 1964 before the House Committee on the District of Columbia in favor of H.R.

419, a bill to provide for the regulation of the sale of securities in he District of Columbia and the licensing of persons engaged in that ctivity.[3] On June 23, 1964 Chairman Cary also testified before the ubcommittee on Census and Government Statistics of the House ommittee on Post Office and Civil Service in connection with the ubcommittee's inquiry into the reporting and paper work requirements of the various Governmental agencies. During the fiscal year he Commission analyzed a total of 37 bills and legislative proposals ubmitted by Congressional Committees or the Bureau of the Budget.

[3] The bill was enacted into law on August 30, 1964, as Public Law 88–503.

PART III

REVISION OF RULES, REGULATIONS AND FORMS

Several new rules were either adopted or proposed during the 1964 fiscal year as a direct result of recommendations made in the Report of the Special Study of Securities Markets. In addition, the Commission maintains a continuing program of reviewing its rules, regulations and forms in order to determine whether any changes are appropriate. Certain members of the staff are specifically assigned to this task, but changes are also suggested, from time to time, by other members of the staff and by persons outside of the Commission who are subject to the Commission's requirements or who have occasion to work with those requirements in a professional capacity, such as underwriters, attorneys and accountants. With a few exceptions provided for by the Administrative Procedure Act, proposed new rules, regulations and forms and proposed changes in existing rules, regulations and forms are published in preliminary form for the purpose of obtaining the views and comments of interested persons, including issuers and various industry groups, which are given careful consideration.[1] The changes which were made during the fiscal year as well as those proposed changes which were published in preliminary form and were pending at the end of the year are described below.

THE SECURITIES ACT OF 1933

Adoption of Rule 156

During the fiscal year, the Commission adopted Rule 156 which defines as "transactions by an issuer not involving a public offering" in Section 4(1) of the Securities Act of 1933, transactions which are exempted from the Investment Company Act of 1940 by Rule 3c–3, recently adopted thereunder.[2]

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[1] The rules and regulations of the Commission are published in the Code of Federal Regulations, the rules adopted under the various acts administered by the Commission appearing in the following parts of Title 17 of that Code:

Securities Act of 1933, pt. 230.
Securities Exchange Act of 1934, pt. 240.
Public Utility Holding Company Act of 1935, pt. 250.
Trust Indenture Act of 1939, pt. 260.
Investment Company Act of 1940, pt. 270.
Investment Advisers Act of 1940, pt. 275.

[2] Securities Act Release No. 4627 (August 1, 1963).

Rule 3c–3 exempts from the provisions of the Investment Company Act transactions by any insurance company with respect to certain group annuity contracts with employers or their representatives covering at least 25 employees and providing for the administration of funds held by such companies in one or more so-called "separate accounts" established and maintained pursuant to state law. It has been represented to the Commission that because of the variety and complexity of such contracts, they must be separately negotiated with employers who retain expert advisers, are fully informed in the matter and are in a position to fend for themselves.

The new rule under the Securities Act provides that transactions of the character referred to therein shall come within the rule only if the transaction is not advertised by any written communication which, insofar as it relates to a separate account group annuity contract, does more than identify the insurance company, state that it is engaged in the business of writing such contracts and invite inquiries in regard thereto. The rule provides, however, that the limitation on advertising shall not apply to disclosure made in the course of direct discussion or negotiation of such contracts.

It should be noted that the rule provides an exemption only from the provisions of Section 5 of the Act and does not afford any exemption from the anti-fraud provisions of the Act.

Amendments to Form S–1, Form S–8 and Form S–11

The Commission announced during the fiscal year that it had under consideration amendments to Forms S–1, S–8, and S–11 believed to be necessary and appropriate in view of changes made by the Revenue Act of 1964 in the provisions of the Internal Revenue Code relating to stock options eligible for special tax treatment. (See Section 221 of the Revenue Act of 1964, Public Law 88–272, 78 Stat. 19).[3] These changes limit the types of stock options which are to receive favorable tax treatment; they eliminate the term "restricted stock options," except with respect to options which have already been granted or may be granted pursuant to existing plans or contracts; and they designate other tax-favored options as "qualified" or as options granted pursuant to "employee stock purchase plans."

The three forms, which are used for the registration of securities under the Securities Act, require the furnishing of certain information regarding options to purchase securities. The proposed amendments were designed to make these forms consistent with the Internal Revenue Code as amended, i.e., to provide for all tax-favored options the

[3] Securities Act Release No. 4686 (April 21, 1964); Securities Act Release No. 4690 (May 12, 1964).

same exemptive or other favorable treatment as had been extended to the previous tax-favored options.

Subsequent to the close of the fiscal year, the proposed amendments were adopted.[4]

THE SECURITIES EXCHANGE ACT OF 1934

Amendments of Rules 10b–6 and 16b–3 and Form 10

In view of the changes made by the Revenue Act of 1964 in the provisions of the Internal Revenue Code relating to stock options eligible for special tax treatment, as previously described,[5] the Commission announced during the fiscal year that it had under consideration the adoption of amendments to Rules 10b–6 and 16b–3 and Form 10 under the Securities Exchange Act of 1934, which would conform those rules and the form to the changes in the Code.[6]

Form 10 is used for the registration of securities on a national securities exchange. Rule 10b–6 makes it unlawful for certain persons participating or expecting to participate in a distribution of securities, including the issuer of the securities involved in such distribution, to purchase any such security, or any security of the same class or series, until completion of their participation in the distribution, subject to specified exceptions. Paragraph (e) of the rule exempts from its provisions certain distributions pursuant to stock option plans. Rule 16b–3 provides an exemption from the insider trading provisions of Section 16(b) for the acquisition of stock options pursuant to a plan meeting specified conditions.

The proposed amendments were adopted subsequent to the close of the fiscal year.[7]

Adoption of Rule 11a–1

During the fiscal year, the Commission adopted a new Rule 11a–1 [8] under Section 11 of the Exchange Act to limit or restrict floor trading on national securities exchanges. The rule provides that no member of a national securities exchange may, while on the floor of such exchange or other premises made available for the use of members generally, initiate any transaction in any security traded on the exchange for any account in which he has an interest or in which he is vested with more than the usual broker's discretion, unless the transaction

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[4] Securities Act Release No. 4718 (August 27, 1964). Corresponding amendments were made to Form 10 and Rules 10b–6 and 16b–3 under the Securities Exchange Act of 1934.

[5] See p. 12, *supra*.

[6] Securities Exchange Act Release No. 7293 (April 21, 1964); Securities Exchange Act Release No. 7315 (May 12, 1964).

[7] Securities Exchange Act Release No. 7403 (August 27, 1964).

[8] Securities Exchange Act Release No. 7330 (June 2, 1964).

comes under specified exemptions or conditions. An important exemption relates to transactions effected in conformity with a plan adopted by an exchange designed to eliminate floor trading activities not beneficial to the market, provided such plan is approved by the Commission.

The propriety of floor trading by members has been a highly controversial subject over the years and was one which particularly concerned Congress in 1934 in its consideration of the Exchange Act. Although early drafts of the legislation contemplated a complete prohibition of the practice, the statute as finally enacted included in Section 11(a) a broad grant of authority to the Commission to prescribe such rules and regulations as it might deem necessary to either regulate or prevent floor trading by members. The Commission in the past preferred not to adopt its own rules but relied instead upon rules adopted by the exchanges to control floor trading. Experience demonstrated, however, and studies by the Commission confirmed, that regulation by the exchanges was not effective and in many respects misdirected. Floor traders retained their significant and unwarranted private trading advantage in the market without contributing any corresponding benefit to public investors, continued to concentrate their activities in the more active stocks where member trading is least needed, continued to accentuate price movements and frequently interfered with the orderly execution of public brokerage orders by delaying their consummation or by adversely affecting the price at which they are executed. Rule 11a–1 and the exchange plans adopted pursuant to it are intended to provide a comprehensive system for the regulation of floor trading.

Both the New York Stock Exchange and the American Stock Exchange have adopted floor trading plans which have been approved by the Commission and declared effective.[9] The regional exchanges have been granted exemptions from the provisions of the rule.

The NYSE and AMEX plans are essentially identical and provide for an exemption from the floor trading prohibition for a new member category known as the "registered trader." These members will be required to meet capital requirements over and above the capital required for other member activities and will be required to pass an examination on the rules and requirements applicable to registered traders. They will be prohibited from executing brokerage orders and floor trading in the same security during a single trading session, will be compelled by a series of new rules to conduct their business

[9] Securities Exchange Act Releases No 7330 (June 2, 1964) and No. 7374 (July 23, 1964), respectively.

in a way calculated to contribute to the orderliness of the market and will be prohibited from engaging in transactions which would have a disruptive effect upon the market. Finally, they will be required to yield priority, precedence or parity to public orders. The Commission anticipates that the net effect of Rule 11a–1 and these exchange plans will be to restrict floor trading to a small group of professional dealers whose activities will be of maximum assistance to the public in the execution of orders on the exchange.

Amendment of Rule 14a–3

Rule 14a–3 relates to the information to be furnished to security holders in connection with the solicitation of proxies. It provides, among other things, that where the management of an issuer solicits proxies for an annual meeting of security holders for the purpose of electing directors, its proxy statement shall be accompanied or preceded by an annual report to such security holders containing such financial statements for the last fiscal year as will in the opinion of management adequately reflect the financial position and operations of the issuer. During the fiscal year, the Commission adopted certain amendments to the rule.[10]

The amended rule requires the inclusion of consolidated financial statements of the issuer and its subsidiaries in such annual reports to security holders if such statements are necessary to reflect adequately the financial position and results of operations of the issuer and its subsidiaries. However, in such cases the individual financial statements of the issuer may be omitted.

Compliance with the requirements for financial statements filed with the Commission is not required, but any material differences between the principles of consolidation or other accounting principles and practices, or methods of applying accounting principles or practices, applicable to such statements and those reflected in the report to security holders must be noted and the effect thereof reconciled or explained in such report. Provision is made, however, for the omission of details and for suitable condensation in the financial statements included in the report to security holders, provided this does not under the circumstances result in the presentation of misleading financial statements.

The amended rule provides that the financial statements included in reports to security holders shall be certified by independent public or certified public accountants, unless certification is not required in annual reports filed with the Commission or the Commission finds that certification would be impracticable or would involve undue effort

[10] Securities Exchange Act Release No 7324 (May 26, 1964).

or expense. The amended rule also includes certain other minor changes.

Amendment to Rules 13a–15 and 15d–15 and Form 7–K

Rules 13a–15 and 15d–15 require certain real estate companies to file quarterly reports with respect to distributions to shareholders. Form 7–K is the form prescribed for such reports. During the fiscal year, the Commission adopted certain amendments to Rules 13a–15 and 15d–15 and Form 7–K.[11]

The rules as amended require the filing of quarterly reports on Form 7–K by real estate investment trusts and by real estate companies which as a matter of policy or practice make distributions to shareholders from sources other than current or retained earnings. Other real estate companies are required to file reports with respect to quarters in which a distribution is made from a source other than current or retained earnings. The amended rules provide for the filing of reports not more than 60 days after the end of the fiscal quarter to which they relate except that the report for the last quarter of the fiscal year must be filed not more than 120 days after the close of the fiscal year. Prior to the amendment the quarterly reports were required to be filed within 45 days after the close of the quarter. The extension of the period for filing reports for the first three quarters should provide adequate opportunity for the collection of information called for by the report by issuers holding numerous properties. The extension of the period for filing the report for the fourth quarter should provide opportunity for reflecting in the information reported any year-end adjustments made in connection with the annual audit of the issuer's accounts or otherwise.

Form 7–K has been amended to eliminate the two-column reporting previously required and to clarify the language of the items. In particular, the form has been amplified to provide directions for treatment of minority interests, mortgages received on the sale of property and businesses acquired during the period covered by the report.

Adoption of Rule 15c2–7

The rule implements a recommendation of the Report of the Special Study of Securities Markets designed to improve the reliability and informativeness of the wholesale quotations system through which dealers advertise their buying or selling interests in securities traded over-the-counter. The "sheets" published by the National Quotation Bureau, Inc., are the primary medium for the dissemination of wholesale or "inside" quotations among broker-dealers in the over-the-

[11] Securities Exchange Act Release No. 7246 (February 28, 1964).

counter markets. Broker-dealers use the sheets to communicate buying and selling interests in securities by placing their names in the sheets, together with accompanying quotations. However, if a broker-dealer submits a quotation to the sheets on behalf of another broker-dealer, there is no indication in the sheets that the appearing broker-dealer is quoting a market on behalf of another. The Special Study pointed out that the failure to differentiate in any way quotations entered for correspondents and quotations representing multiple expressions of the same market, prevents persons using the sheets from determining the actual depth and activity of the market for a particular security and the identity of the actual primary market makers for such security. This failure to differentiate quotations entered by one broker-dealer on behalf of another from other quotations may also result, as documented by the Special Study, in the use of the sheets for fraudulent or manipulative purposes.

The purpose of Rule 15c2–7 is to insure that an inter-dealer quotation system clearly reveals those instances where two or more quotations in different names for a particular security represent a single quotation or where one broker-dealer appears as a correspondent of another. The rule requires a broker-dealer who is a correspondent for another firm for a particular security and enters quotations in the sheets to inform the service of the correspondent arrangement and the identity of his correspondent. By requiring disclosure of the correspondent, as well as of the fact of such an arrangement, the rule permits users of the sheets to determine the identity of dealers making an inter-dealer market for a security—a fact which may be extremely pertinent in evaluating its marketability.

The rule also requires that where two or more broker-dealers place quotations in the sheets pursuant to any other arrangement between or among broker-dealers, the identity of each broker-dealer participating in any such arrangement or arrangements, and the fact that an arrangement exists, must be disclosed. Because of the variety of market-making arrangements between broker-dealers resulting in appearances in the sheets, the rule does not limit the type of arrangement covered; the purpose of the rule is to cover any arrangement between broker-dealers, such as joint accounts, guarantees of profit or against loss, commissions, mark-ups, mark-downs, indications of interest and accommodations.[12]

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[12] The rule was adopted shortly after the end of the fiscal year. See Securities Exchange Act Release No. 7381 (August 6, 1964).

Adoption of Rule 15c3–2

The Special Study of Securities Markets found that many customers of broker-dealers were unaware (1) that when they leave free credit balances (funds which the customer has an unrestricted right to withdraw) with a broker-dealer the funds generally are not segregated and held for the customer but are commingled with other funds of the broker-dealer and used in the operation of his business, and (2) that the relationship between the broker-dealer and the customer as a result thereof is that of debtor-creditor. The purpose of Rule 15c3–2 is to put customers on notice that free credit balances left with the broker-dealer may be used in the business and therefore may be at risk. The rule, effective August 3, 1964, prohibits a broker or dealer from using in his business any funds arising out of any free credit balance carried for the account of any customer unless he has established adequate procedures pursuant to which each such customer will be given or sent, together with or as a part of the customer's statement of account, whenever sent, but not less frequently than once every 3 months, a written statement informing the customer of the amount due, and containing a written notice that such funds are not segregated and may be used in the operation of the business of the broker-dealer, and that such funds are payable on demand. The rule provides an exemption for a banking institution supervised and examined by state or Federal authority having supervision over banks.[13]

Adoption of Rule 16b–9

During the fiscal year, the Commission adopted a new Rule 16b–9 which exempts from the operation of Section 16(b) of the Securities Exchange Act of 1934 certain transactions in which shares of stock are exchanged for similar shares of stock of the same issuer.[14] Section 16(b) provides for the recovery, by or on behalf of an issuer of equity securities registered under the Exchange Act, of short-term trading profits realized by directors, officers and principal security holders of the issuer. The Commission is authorized to exempt from Section 16(b) transactions not comprehended within the purpose of that section.

The new rule exempts from the operation of Section 16(b) any acquisition or disposition of shares of stock of an issuer in exchange for an equivalent number of shares of another class of stock of the same issuer pursuant to a right of conversion under the terms of the issuer's charter or other governing instruments. The exemption is available only if (1) the shares surrendered and those acquired in

[13] Securities Exchange Act Release No. 7325 (May 27, 1964).
[14] Securities Exchange Act Release No. 7118 (August 19, 1963).

exchange therefor evidence substantially the same rights and privileges except that the shares surrendered may, in the discretion of the board of directors, receive a lesser dividend than the shares for which they are exchanged and (2) the transaction was effected in contemplation of a public sale of the shares acquired in the exchange. This rule is intended to relate only to the typical Class A and B common equity securities.

Adoption of Rule 17a–8

During the fiscal year, the Commission adopted Rule 17a–8,[15] which requires national securities exchanges to file reports of proposed rule changes with the Commission prior to any final exchange adoption of such changes. Under the Exchange Act the Commission has the responsibility for overseeing the self-regulatory functions of national securities exchanges. Under Sections 11, 19(b) and other sections of the Act, the Commission has broad powers and responsibilities with respect to the rules of such exchanges, including the power to alter or supplement exchange rules in specified areas of exchange operations and the power to enact its own rules in other areas if the exchanges' rules are inadequate to protect investors and assure fair dealing. Chapter XII of the Special Study Report concluded that the Commission's existing procedures for the review of exchange rules did not appear to be sufficient to assure the needed continuous oversight on the part of the Commission to enable it to discharge its responsibilities under the Act. The Report recommended that the exchanges be required to file all proposed rule changes with the Commission in advance of effectiveness, as has always been required in the case of rules of the National Association of Securities Dealers, Inc. Rule 17a–8 was adopted in response to that recommendation and is intended to afford the Commission an adequate interval for orderly review of new exchange rules or amendments before they become effective.

The rule provides that each national securities exchange shall file a report of any proposed change in, or addition to, its rules not less than 3 weeks before it is submitted for any action by the membership or any governing body of the exchange. If any substantive change is made in the proposal after the report is filed with the Commission, a new 3-week notice is required unless the change is made to conform it to a suggestion made by the Commission. The rule also provides that if emergencies arise in which a report cannot be filed as provided above, the exchange shall give the Commission as much advance notice as the circumstances permit, together with a written statement of the reasons why the filing of a report as required was impracticable.

[15] Securities Exchange Act Release No. 7253 (March 3, 1964).

Proposed Rule 17a–9

During the fiscal year, the Commission staff drafted a proposed rule and related reporting forms requiring broker-dealers to report certain information concerning over-the-counter trading in common stocks traded on national securities exchanges. The proposed rule, to be designated Rule 17a–9, was published for public comment shortly after the end of the fiscal year.[16] It is intended to implement recommendations of the Special Study of Securities Markets.

The Report of the Special Study describes a striking increase in the volume of off-board trading in common stocks traded on the New York Stock Exchange and other national securities exchanges in recent years. But the Study found "an acute lack of data" concerning this trading, which it described as the "third market." The Study recommended correction of this deficiency by establishment of a system for the identification of market makers and for reporting information concerning trading in this market.

The proposed rule and reporting forms are designed to enable the Commission to obtain information on the third market on a continuous basis and thus keep abreast of any regulatory problems which may develop therein. It would obtain two basic types of information: (1) an identification of broker-dealers making off-board markets in common stocks traded on any national securities exchange; and (2) summaries of over-the-counter trading in common stocks traded on the New York Stock Exchange.

Proposed Amendments to Form 8–K

Form 8–K is prescribed for current reports filed pursuant to Sections 13 and 15(d) of the Securities Exchange Act. During the 1962 fiscal year, the Commission announced that it had under consideration certain proposed amendments to Form 8–K and invited public comments.[17] The amendments are designed to bring to the attention of investors prompt information regarding matters such as the pledging of securities of the issuer or its affiliates under circumstances that a default will result in a change in control of the issuer, changes in the board of directors otherwise than by stockholder action, the acquisition or disposition of a significant amount of assets otherwise than in the ordinary course of business, interests of management and others in certain transactions, and the issuance of debt securities by subsidiaries. These amendments were still under consideration at the close of the last fiscal year.

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[16] Securities Exchange Act Release No. 7360 (July 8, 1964).
[17] Securities Exchange Act Release No. 6770 (April 5, 1962).

THE INVESTMENT COMPANY ACT OF 1940

Amendment of Rule 3c–3

During the fiscal year, the Commission invited public comments on a proposed amendment of Rule 3c–3 under the Investment Company Act,[18] and, shortly after the close of the fiscal year, the rule was amended.[19]

Prior to its amendment, Rule 3c–3 exempted from the Act transactions of insurance companies with respect to group annuity contracts entered into in connection with a plan of retirement which meets the requirements of Sections 401 or 404(a)(2) of the Internal Revenue Code and which provides for the allocation of part or all of the employer's contributions to a separate account established and maintained pursuant to legislation under which income, gains and losses, whether or not realized, from assets allocated to the account were credited to or charged against that account without regard to other income, gains or losses of the insurance company.[20] In order to qualify for the exemption the group annuity contract was required to provide that the retirement benefits for covered employees would be payable in fixed dollar amounts, i.e., the contract could not permit the retirement benefits payable to employees to reflect or be measured by the investment results of the assets allocated to the separate account.

The rule as amended permits group variable contracts to provide for employees' retirement benefits to be payable in varying amounts but the benefits may vary to the extent, and only to the extent, of the employer's contributions to the separate account. No variable benefits are permitted in respect of the contributions of the employees. In all other respects, the restrictions and conditions of the rule remain intact.

Adoption of Rule 12d–1

During the fiscal year the Commission invited public comments on a proposed Rule 12d–1 under the Investment Company Act,[21] and after the close of the fiscal year, the rule was adopted.[22] Rule 12d–1 provides conditional exemptions from the provisions of Section 12(d)(3) of the Act which prohibits a registered investment company from purchasing or acquiring any security issued by, or any other interest in the business of, a person who is a broker, a dealer, is engaged in the business of underwriting, or is an investment adviser of an investment company or an investment adviser registered under the Investment Advisers Act of 1940.

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[18] Investment Company Act Release No. 3957 (April 13, 1964).
[19] Investment Company Act Release No. 4007 (July 2, 1964).
[20] See 29th Annual Report, p. 18.
[21] Investment Company Act Release No. 3896 (January 15, 1964).
[22] Investment Company Act Release No. 4044 (September 4, 1964).

The purpose of the rule is to permit registered investment companies, under specified circumstances, to retain in, or acquire for, their portfolios securities of companies which are directly or indirectly engaged in the businesses referred to in Section 12(d)(3), provided that the portfolio companies are primarily and predominantly engaged in other businesses and derive or will derive a relatively insignificant portion of their gross revenues from such businesses.

The exemption is available for securities holdings or acquisitions of securities by registered investment companies if the portfolio company, during each of its most recent 3 fiscal years, derived not more than 15 percent of its total gross revenues from the specified businesses, and if the registered investment company and all companies under the same or affiliated management as the registered company immediately after the acquisition do not, in the aggregate, own more than 10 percent of the total outstanding voting stock of the portfolio company. An exemption is also available for the purchase by a registered investment company of an unlimited percentage of the securities of a portfolio company if the portfolio company, during each of its most recent 3 fiscal years, has not derived more than 1 percent of its total gross revenues from the businesses referred to in Section 12(d)(3) of the Act.

A registered investment company which claims an exemption must examine its portfolio semi-annually to determine whether its holdings are in compliance with the conditions prescribed in the rule, and, if any holding is not, the company is required to dispose of it within 90 days.

The rule further exempts all investments by registered investment companies, without regard to the percentage of voting securities held, in certain types of businesses, such as small loan, factoring and finance companies which technically might be regarded as being engaged in a securities business.

Amendment of Rule 17a–6

During the fiscal year, the Commission amended Rule 17a–6 under the Investment Company Act to provide certain additional exemptions from the prohibitions of Section 17(a) of the Act.[23]

Prior to its amendment, Rule 17a–6 exempted from the prohibitions of paragraphs (1) and (3) of Section 17(a) of the Act the sale of securities or other property to, and the borrowing of money or other property from, a registered investment company which is a small business investment company licensed under the Small Business Investment Act of 1958 (SBIC) where such transactions were prohibited

[23] Investment Company Act Release No. 3968 (April 29, 1964).

solely because the SBIC owns, controls, or holds with power to vote, voting securities of a small business concern to an extent that creates an affiliation within the meaning of the Act.

The purpose of both the previous rule and of the rule as amended is to eliminate the need to file and process applications for exemption from Section 17(a) in circumstances in which it appears that there is no likelihood of overreaching of the investment company and that the transaction would not be unreasonable or unfair to such company. The rule as amended is broader in that it extends the exemption so as to include not only transactions to which a registered investment company, which is an SBIC, is a party, but also transactions to which another type of registered investment company (generally referred to as a "venture capital investment company"), or a company controlled by such a registered investment company, is a party. The rule now specifies certain classes of persons who have an affiliation with the registered investment company of a character which creates the possibility of overreaching of the investment company in a transaction involving the registered investment company and such persons. An exemption under the rule is not available, if such a person is a party to the transaction, or has or within 6 months prior to the transaction had, or pursuant to an arrangement will acquire, a direct or indirect financial interest in a party (except the registered investment company) to the transaction.

The amended rule also exempts transactions involving a registered investment company other than an SBIC or venture capital investment company and a company controlled by or affiliated with the registered investment company, if under the standards set forth in the preceding paragraph it appears that there is no likelihood of overreaching of the investment company, and if all the outstanding securities of the controlled or affiliated company are beneficially owned by not more than 100 persons.

The rule as amended deletes the requirement of the original Rule 17a–6 that the pertinent details of each transaction for which exemption is claimed under the rule shall be reported by the investment company in its next annual report to stockholders and in a report filed with the Commission within 30 days after the end of each semi-annual accounting period of the investment company.

Amendment of Rule 17g–1

During the fiscal year the Commission invited public comments on a proposed amendment of Rule 17g–1,[24] and after the close of the fiscal

[24] Investment Company Act Release No. 3922 (March 3, 1964).

year, an amended rule was adopted.[25] Rule 17g–1 requires that each registered management investment company provide and maintain a fidelity bond against larceny and embezzlement covering each officer and employee of the investment company who may have access to securities or funds of the company.

The rule as amended adds to the provisions of the prior rule requirements that the amount of the fidelity bond be determined at least once each year, and that the registered company shall file with the Commission a copy of each amendment to the bond, shall inform each of its directors of any proposed cancellation, termination or modification of the bond, and shall furnish to such directors and to the Commission information as to the making and settlement of claims under the bond.

In addition, the amended rule requires that each bond must provide, in substance, that if the insurance company proposes to cancel, terminate or modify the fidelity bond, it shall so notify the registered company and the Commission not less than 30 days prior to the effective date of such action.

The rule also places the obligation for filing information with respect to the making and settlement of claims under fidelity bonds on the registered company, rather than requiring, as originally proposed, that the bond contain provisions pursuant to which the insurance company would furnish the information to the Commission. The adopted rule also provides that this information shall be nonpublic unless the Commission determines to the contrary.

Proposed Amendment of Rule 20a–2

During the fiscal year the Commission invited public comments on a proposed amendment of Rule 20a–2.[26] The rule presently requires that a proxy statement relating to a registered investment company include certain information with respect to, among other things, the investment advisory contract, ownership and control of the investment adviser, and interests of the management of the investment company in the investment adviser. Except where the investment adviser is a bank, a balance sheet of the investment adviser must be included, unless the Commission, for good cause, permits the omission of such balance sheet. Certain information also is required with respect to the relationship between the investment company or the investment adviser and the principal underwriter of the investment company's securities. Where action is to be taken by the security holders of the investment company with respect to an investment advisory contract, information is also to be included with respect to such contract

[25] Investment Company Act Release No. 4020 (July 24, 1964).
[26] Investment Company Act Release No. 3931 (March 18, 1964).

and with respect to certain collateral arrangements or understandings in connection therewith.

The effect of the proposed revision of Rule 20a–2 would be to require: (1) disclosure of information with respect to the principal underwriter, the prospective principal underwriter and the principal underwriting contract comparable to that now required with respect to the investment adviser, the prospective investment adviser and the investment advisory contract; (2) disclosure of certain financial information concerning (*a*) the investment company, (*b*) the investment advisory contract where action is to be taken by security holders with respect thereto, and (*c*) the principal underwriting contract where action is to be taken by security holders with respect thereto; and (3) the inclusion of such financial information with respect to both the investment advisory contract and the principal underwriting contract if action is to be taken by security holders with respect to either and the investment adviser and principal underwriter are the same person or one is an affiliated person of, or an affiliated person of an affiliated person of, the other.

This matter was pending at the close of the fiscal year.