REPORT BY THE

Comptroller General

OF THE UNITED STATES

LM107352

Securities And Exchange Commission Should Strengthen Its Inspection Oversight Of The National Association Of Securities Dealers

The Congress delegated regulation of the over-the-counter securities market to privately financed national securities organizations. The National Association of Securities Dealers is the only such organization which has registered with the Commission to date. GAO identified a number of weaknesses impairing the effectiveness of the Commission's inspection oversight of the Association and recommends ways to correct them.

This review was made at the request of the Subcommittee on Oversight and Investigations, House Committee on Interstate and Foreign Commerce.

UNITED STATES GENERAL ACCOUNTING OFFICE

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OCTOBER 5, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-133227

The Honorable John E. Moss, Chairman
Subcommittee on Oversight and Investigations
Committee on Interstate and Foreign Commerce
House of Representatives

Dear Mr. Chairman:

This report is in response to your June 16, 1978, letter requesting that we review the Securities and Exchange Commission's oversight of the self-regulatory activities of the National Association of Securities Dealers, Inc. The report discusses the need for more formal guidelines and procedures, for broader inspection oversight, and for action to resolve several additional problems. It makes recommendations to improve the Commission's inspection oversight of the Securities Dealers Association.

As requested by your office, we did not take the time to obtain formal written comments from the Commission and the Association; however, we discussed the draft report with Commission and Association officials and considered their comments in preparing the report.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the report date. At that time we will send copies to the Commission and the Association and to other interested parties and make copies available upon request.

Sincerely yours,

R F Keller

ACTING Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS, HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

SECURITIES AND EXCHANGE COMMISSION SHOULD STRENGTHEN ITS INSPECTION OVERSIGHT OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS

D I G E S T

The privately financed National Association of Securities Dealers acts as the self-regulator of member securities firms and persons who trade in securities not sold on the stock exchanges. There are about 2,800 firms that are members of the Association. In 1977 the Association conducted 2,032 routine examinations, 891 financial and operational examinations, and 402 special examinations to determine whether administrative rules and Federal securities laws applicable to such firms are being followed. As a result of these reviews, 307 formal actions were taken against members and this in turn resulted in

--expulsion of 18 firms from the Association,

--barring 113 individuals from further association with the National Association of Securities Dealers and member firms,

--suspension of 5 firms and 62 individuals,

--collection of $212,300 in fines, and

--numerous other informal actions.

The Securities and Exchange Commission, which has regulatory oversight of the Association's activities, makes its own reviews of the Association's examination efforts. As a result of its work, the Commission has expressed concern about the adequacy of the Association's examination staff.

The Commission staff has an informal oversight approach--largely oral--which has produced only limited documentation on the differences of opinion concerning the Association's

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staffing needs for adequate self-regulation. Because of this informal approach, the Commission has not established guidelines to objectively judge examination staffing needs. Other longstanding problems may exist as a result of the informal approach.

GAO's review indicates that the Commission's staff has not dealt aggressively enough with inspection oversight problems. The Commission branches concerned with this oversight usually deal with the Commission indirectly through intermediate levels and generally do not have access to top management.

In 1977 the Commission Chairman noted that the Commission should be exercising an aggressive oversight of organizations such as the Association. Guidelines for inspection oversight in accordance with Commission policy are lacking.

Commission inspection oversight is heavily concentrated on the continuous, routine administration of the Association's district offices and on its members' conformance with administrative rules and Federal securities laws.

GAO believes the Commission's inspection oversight ought to reach beyond what the Association <u>is doing</u> to what it <u>might be</u> doing in the public interest. Commission staff has reviewed only a few activity areas at the Association's headquarters. More inspections of such areas would give Commission oversight a better focus on policy issues and systemwide Association operations. GAO noted other problems with the Commission's inspection oversight. Its staff should be

--obtaining information developed by the Association's internal review group, national committees, and Board of Governors as an aid to carrying out its responsibilities,

--preparing and executing more meaningful plans for inspection oversight,

--revising its procedures for communicating inspection oversight findings to the Association,

--improving its followup on corrective actions taken by the Association, and

--controlling delays in processing complaints in and reviews of disciplinary actions.

RECOMMENDATIONS

The Commission should

--develop guidelines to assist in determining the adequacy of the Association's examiner staffing,

--issue guidelines for use by the staff assigned to inspection oversight of the Association, and

--obtain and use Association policy information to develop an oversight perspective which reaches beyond what the Association is doing to what it might be doing to promote the public interest.

The Commission should also

--improve its inspection planning,

--revise its procedures for communicating and following up on findings, and

--eliminate delays that occur in processing complaints.

COMMISSION AND ASSOCIATION COMMENTS

As requested by the Subcommittee, GAO did not obtain formal written comments from the Commission and the Association. Their informal comments were considered and changes to the report were made where appropriate. They felt that GAO had overstated the significance of its findings and considered the scope of the review too narrow to support GAO's conclusions.

GAO believes it has brought to the surface issues and problems that have remained unresolved for years. The Commission has not tried to probe deeply into the areas which it is or should be concerned about to determine their significance and to establish a more structured dialog with the Association to resolve them. GAO therefore believes its conclusions and recommendations are in order.

Contents

ABBREVIATIONS

GAO General Accounting Office

NASD National Association of Securities Dealers

CHAPTER 1

ROLE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS IN THE FEDERAL REGULATORY SYSTEM FOR SECURITIES

The Chairman, Subcommittee on Oversight and Investigations, House Committee on Interstate and Foreign Commerce, asked in a letter dated June 16, 1978, that we review the Securities and Exchange Commission's oversight of the self-regulatory activities of the National Association of Securities Dealers, Inc. (NASD). In seeking clarification from the Chairman's office on the scope of the assignment, our representatives were told to focus primarily on the Commission's inspection oversight of NASD, which is an important responsibility of the Commission's Division of Market Regulation. The inspections are a major means the Commission uses to determine how NASD is regulating those under its jurisdiction and whether such regulation fosters an efficient securities market and adequate investor protection.

The Maloney Act of 1938 (15 U.S.C. 78o-3), embodied in the Securities Exchange Act of 1934 as Section 15A, authorized the formation of national securities associations to supervise the over-the-counter securities market. (Securities transactions which do not take place on an exchange are said to take place in the over-the-counter market.) NASD registered with and was approved by the Commission as a national securities association in 1939. Although the Exchange Act provides for the registration of more than one national securities association, to date only NASD has registered with the Commission.

NASD ORGANIZATION AND OPERATIONS

In carrying out its responsibilities, NASD regulates its members through a nation-wide field examination program. It monitors the financial and operational conditions of members and their trading practices. It also monitors such areas as members' new-issue distribution practices and their dealings with customers. It carries out a number of other regulatory functions including the review of members' sales literature. The Securities Acts Amendments of 1975 (15 U.S.C. 78a et seq.) gave NASD the additional responsibility for enforcing members' compliance with rules for municipal securities.

The Board of Governors is NASD's controlling body and establishes its national policy. The Board is comprised of 27 members--25 from the securities industry and 2 from outside the industry. With the exception of the NASD president, members of the Board and its various committees serve without compensation.

Thirteen district business conduct committees (whose members are elected by NASD's membership) and various standing and special committees work directly with the Board of Governors.

The enforcement of NASD's bylaws, rules, and policy interpretations rests primarily with the district business conduct committees. In addition to these committees, there are 23 standing and special committees whose jurisdictional areas include arbitration, automation, national market system trading, financial responsibility, corporate financing, options, qualifications of individuals, and uniform-practice procedures.

These bodies are assisted by a staff headed by the president and other personnel located at NASD's headquarters in Washington, D.C., and at district offices. The president and four senior vice-presidents comprise the senior management group. Each district is staffed by a district director, assistant director(s), supervisor(s), and a complement of examiners.

As of July 31, 1978, NASD employed 535 persons, of whom approximately 445 were directly involved in regulatory duties; the others, in regulatory support activities. The district offices employ 239 professionals, including 180 examiners.

As of July 31, 1978, 2,808 firms held membership in NASD. These members operated a total of 6,288 branch offices and had 191,268 individuals registered with NASD as representatives and principals. Of the 2,808 firms, 2,326 were subject solely to NASD regulation, and 482 firms were subject to regulatory oversight by both NASD and one or more of the stock exchanges.

NASD is financed by its members primarily through admission fees, dues, and membership assessments. In fiscal year 1977, NASD reported revenues of $27.9 million and expenses of $24.3 million. The National Association of Securities Dealers Automated Quotations, Inc., a wholly owned subsidiary providing over-the-counter trading information, accounted for $12.2 million of the revenues and $10.8 million of the expenses.

NASD's Surveillance Department directs district office operations and Washington-based operations concerned with automated reports, district administration support, and antifraud matters.

The over-the-counter marketplace which NASD supervises is large and diverse. It includes about 30,000 to 40,000 common stocks of public corporations. About 5,000 of these could be described as actively traded. Most corporate bonds and many government obligations are traded in the over-the-counter market. All new issues of securities are distributed in the over-the-counter market. Mutual fund shares, tax sheltered programs, and most bank and insurance stocks are also traded in the over-the-counter market.

RESULTS OF NASD EXAMINATIONS

In 1977 NASD conducted 2,032 routine examinations, 891 financial and operational examinations, and 402 special examinations. A total of 307 formal actions were taken by NASD district business conduct committees against members and persons associated with members during that year. As a result of these actions, NASD expelled 18 firms, barred 113 individuals from further association with NASD and member firms, and suspended 5 firms and 62 individuals. NASD collected $212,300 in fines, and took numerous other informal actions during 1977, such as letters of caution and staff interviews.

CHAPTER 2

COMMISSION OVERSIGHT OF NASD

The Congress has, by legislation, delegated certain regulatory functions in the securities markets to the industry's self-regulatory organizations, subject to the oversight of the Commission. Industry and Government regulation are complementary components of the self-regulatory process, and self-regulatory organizations like NASD are permitted to exercise quasigovernmental powers over their members.

The House report on the bill which became the Securities Exchange Act of 1934 (15 U.S.C. 78a, et seq.) pointed out, in discussing the stock exchanges as self-regulatory organizations, that:

> "Although a wide measure of initiative and responsibility is left with the exchanges, reserved control is in the Commission if the exchanges do not meet their responsibility."

As an oversight concept, the Commission's reserved control has been referred to as the "big stick" or the "shotgun behind the door." Although this correctly implies that the Commission is empowered to inject itself directly into the self-regulatory process, there are also a number of less severe actions available by which the Commission can modify self-regulatory policies or actions without disrupting the basic commitment to self-regulation.

It is clear from the Commission's 1963 Special Study that the self-regulatory organizations are to perform the day-to-day regulation of the markets:

> "Regulation in the field of securities should continue to be based on the principle of giving maximum scope to self-regulation wherever and to the extent that a regulatory need can be satisfactorily met through self-regulation."

The view has been frequently expressed that the industry regulates itself and therefore is not regulated by the Government. Such a conception of self-regulation is seriously misleading. Although broad missions have been delegated to self-regulatory organizations, such a concept fails to recognize the essential and continuing role of the Federal Government. Industry regulation and Government regulation are not alternative, but complementary, components of the regulatory process.

The relationships between self-regulators and the Commission are sometimes referred to as "partnerships" or "cooperative" regulatory systems. Although such references attempt to clarify self-regulatory relationships, they are nevertheless misleading unless tempered with the knowledge that industry and Government under self-regulation do not have the same regulatory perspective, responsibilities, or powers.

COMMISSION GROUPS OVERSEEING NASD ACTIVITIES

It is difficult to measure accurately the resources which the Commission expends on NASD-related areas of the securities markets. Various groups within the Commission are concerned to different degrees and for different purposes with market activities which are subject to NASD's self-regulation, and hence total Commission oversight is spread among most of its divisions and offices. Commission groups having oversight of NASD include its nine regional offices and, at headquarters, the Divisions of Enforcement, Market Regulation, Corporation Finance, and Investment Management, and the Offices of Economic Research, Consumer Affairs, and General Counsel.

It is the Division of Market Regulation, assisted by the regional offices, which is most directly concerned with overseeing NASD's examination and enforcement programs, its rulemaking, and its overall regulatory policies and procedures. This oversight is performed principally by two offices within the division.

The Office of Self-Regulatory Oversight routinely examines NASD's final disciplinary actions and proposed rules changes. It also makes inspections of NASD district offices, heavily emphasizing the effectiveness of the offices in detecting rule and law violations, handling complaints, and, where appropriate, imposing penalties on members.

The Office of Compliance and Financial Responsibility exercises oversight of NASD through inspections of NASD-member firms and NASD district offices. A large part of the inspection work is delegated to the Commission's regional offices for execution. The major purposes of these inspections are to determine the firms' compliance with the Federal securities laws and to evaluate the inspections which NASD made of its member firms. Among other duties, the Office monitors the condition of firms identified by NASD and by other means as being in or approaching financial difficulty.

SCOPE OF REVIEW

Our review was performed during July and August 1978 in the Washington, D.C., area at Commission and NASD headquarters, the Commission's Washington Regional Office, and NASD's District No. 10 Office. Because of the Subcommittee Chairman's interests and the limitations which the reporting deadline imposed on our examination, we concentrated on the Commission's oversight of self-regulation as it concerned the detection of violations and the disciplinary processes intended to promote compliance with administrative rules and Federal securities laws. We reviewed Commission and NASD procedures, practices, and inspection reports, held discussions with officials of the two organizations, and reviewed other documentation related to inspection oversight.

Our review identified a number of weaknesses impairing the effectiveness of the Commission's inspection oversight of NASD. We discussed our report with officials of the Commission and NASD. We considered their comments and made changes to the extent we deemed appropriate. They felt we had overstated the significance of our findings and considered the scope of our review too narrow to support our conclusions. We believe our review has brought to the surface issues and problems that have remained unsolved for years. The Commission has not tried to probe deeply into the areas which it is or should be concerned about to determine their significance and to establish a more structured dialog with NASD to resolve them. We therefore believe our conclusions and recommendations are in order.

We will in the future follow up on the results of this review and consider the need for examining other self-regulatory issues in greater depth.

CHAPTER 3

NEED FOR MORE FORMAL

PROCEDURES TO RESOLVE LONGSTANDING

INSPECTION OVERSIGHT PROBLEMS

In 1963 and at other times since then the Commission expressed concern about the adequacy of NASD's examination staff. In the years between 1963 and the present, however, the Commission has not established guidelines to objectively judge NASD's staffing needs. Our review indicates that longstanding differences between the Commission and NASD as to the adequacy of NASD's staffing and possibly other problem areas continue because of the Commission's preference for dealing informally in its inspection oversight with NASD.

COMMISSION USES INFORMAL APPROACH

In 1973 the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, published its Securities Industry Study, which was based on a comprehensive 18-month examination of the securities markets and Commission regulation. The study noted that the Commission seldom relied on its formal rulemaking powers in dealing with self-regulatory agencies, preferring an informal approach designed to help the self-regulatory bodies do their part more effectively without confronting them as adversaries. The Subcommittee noted that, under this informal approach, if a self-regulatory body balks at the Commission's recommendations, the Commission generally does nothing instead of using its formal rulemaking powers or applying the sanctions authorized by the act.

The Commission still prefers to operate informally through its staff in its oversight inspections. In general, findings are discussed and disagreements resolved through telephone conversations, conferences, or correspondence with NASD officials. This operational approach is largely oral and produces only limited documentation on problems, opinion differences, and actions taken. Consequently, the public record of differences between staffs of the Commission and NASD is scant, and stalemates between the Commission and NASD could be continuing for years without being brought to the attention of the Congress, the courts, or the public.

COMMISSION QUESTIONS NASD BUDGET FOR EXAMINER STAFF

On several occasions between 1963 and 1978, the Commission expressed concern over NASD's staff resources, including the examination staff.

In reviewing NASD's 1968 fee and assessment schedule and the supporting budget, the Commission commented on NASD's need for additional regulatory and enforcement staff. In its annual report for fiscal years 1975 and 1976, the Commission again expressed concern over the adequacy of NASD's staff for enforcement and surveillance activities.

In 1978 the Commission's staff questioned whether the NASD budget for staffing the examination program was realistic. The Commission staff, however, withdrew its objections to the budget, noting:

> "It would be very difficult, as a practical matter, to coerce the NASD into improving its examination program since the effectiveness of that program is not susceptible to precise measurement by an objective standard."

The Commission approved NASD's fee and assessment schedule with the proviso that NASD would hire additional examiners if needed, using funds accumulated in prior years. We were told by Commission staff that, if the approval had been withheld, NASD's fee and assessment schedule for the previous year would have remained in effect.

In defense of the adequacy of their staffing budget NASD officials informed us that

--since 1963 NASD staff has increased 300 percent while its member firms have declined 35 percent,

--NASD uses sophisticated procedures to determine manpower needs,

--NASD each year meets or exceeds its planned cycles for examinations,

--the field staff is assisted by automated systems for monitoring the financial and operational condition of member firms; and

--since 1972 there has been a sharp reduction in financial failures of securities firms.

Because of time limitations we did not verify the accuracy of this information.

COMMISSION QUESTIONS ADEQUACY OF NASD EXAMINER STAFF

Lack of a sufficient number of adequately trained NASD examiners has been a long-time matter of concern to the Commission. The Commission observed in its 1963 Special Study that:

> "To a large extent, the shortcomings in Association performance noted in this report can be traced directly to material inadequacies in the number of staff personnel at both the national and district levels * * *."

The study also noted that the lack of examiners had resulted in sharp curtailment of enforcement in some districts.

According to the Commission staff, the adequacy of NASD's examiner staff was pursued only intermittently because of more pressing problems. In 1978, however, 15 years after the special study noted material inadequacies in the number of NASD personnel, the Commission staff concluded that the quality of NASD's examination program had been adversely affected by its failure to pay wages high enough to retain experienced examiners. Commission staff expressed concern about the high turnover of examiners and the resulting large number of examiner-trainees who needed substantial supervision to conduct routine examinations.

NASD officials conceded to us that examiner turnover had been a problem. Many of NASD's member firms, for example, hired their examiners. NASD officials held, however, that (1) NASD's regulatory staff was one of the best in the industry and (2) salary levels of NASD employees were reviewed annually on the basis of survey data and were appropriately adjusted. We did not verify the representations of the Commission or NASD with respect to the adequacy of the wage structure for examiners or the effect of the structure on the retention of examiners.

We did review the Commission's inspection reports of NASD district offices from July 1974 to July 1978. The inspection reports indicated that many of the problems identified in the inspections were related to inadequacies in NASD examiner staff. Some of the problem areas identified in inspections were

--superficial review of facts (7 inspections),

--lack of examination followup (2 inspections),

--backlog in processing complaints and disciplinary actions (6 inspections),

--staff determined not to report certain apparent violations to the district business conduct committees (5 inspections), and

--inadequate handling of customer complaints (4 inspections).

Commission staff said we had overstated the importance of the problems the inspections had identified. However, they could not provide a measure of the problems' significance. The Commission does not classify inspection findings by levels of importance nor has it determined how frequently certain types of findings occur within districts or the total system. It has not established criteria on the extent to which certain types of findings should be tolerated. Because the Commission has not developed an analytic framework for evaluation of NASD's examination program, we could not satisfactorily assess Commission inspection findings from a total oversight standpoint.

We reviewed all 16 oversight inspections of brokerage firms made by the Commission's Washington Regional Office between October 1976 and April 1978. The Commission's oversight inspection reports, which compared Commission and NASD findings for the same brokerage firms, ranked most NASD examinations as adequate to good (on a ranking scale of inadequate to excellent). The Commission staff concluded, however, that certain violations which it found at six of the brokerage firms should also have been noted by NASD. Eight of the NASD examinations were considered to be in need of improvement in areas such as financial responsibility, sales practices, and books and records. The conditions encountered in the 16 inspections may or may not be typical of the conditions encountered in the inspection program as a whole.

NASD officials told us that (1) their examination program was of high quality and (2) under a sampling approach to enforcement some violations will go undetected.

They also said that the 16 Commission inspections had not been discussed with them and that they were at a loss to comment on specific findings. A Commission regional official said that most of these inspections probably were discussed with NASD officials at the district level. We could not readily determine from written Commission records whether these inspections had been discussed with NASD. (A weakness in Commission procedures for discussing findings with NASD and for following up on corrective actions is discussed in ch. 6.)

OTHER LONGSTANDING PROBLEMS MAY EXIST

Our review indicates that other longstanding problems may exist as a result of the Commission's informal approach to inspection oversight.

In 1963 the Commission determined that there was a need for more NASD examinations of broker-dealer branch offices. From 1963 to 1972 NASD examined between 763 and 1,571 branch offices a year. In 1973 NASD branch office examinations declined to 322 and in subsequent years declined still further. The Commission and NASD officials stated that the 1963 findings on the need for branch office examinations were not pursued because the attention of the organizations was focused on other difficulties, such as paperwork problems experienced by many brokerage firms in the late 1960s.

A September 1977 Commission staff letter asked NASD about the number of branch examinations which would be performed in fiscal year 1978. The Commission was informed that NASD did not have a prescribed cycle for examining branch offices. There were informal discussions of the matter and in December 1977 NASD notified the Commission that it would start a pilot program of routine examinations of branch offices. Much of the preparatory work for this limited program has been completed.

CONCLUSION AND RECOMMENDATION

How serious are the Commission's findings of inadequacies in NASD's examiner staff? We could not determine the answer, nor do we believe the Commission could, without doing much additional work, given the lack of guidelines and the nature of other data available to it. We therefore recommend that the Commission develop guidelines to assist it in determining the adequacy of NASD's examiner staffing.

CHAPTER 4

NEED FOR GUIDELINES TO ASSIST COMMISSION

STAFF IN INSPECTION OVERSIGHT

The intent of the self-regulatory system created by the Maloney Act of 1938 was, in broad terms, to have NASD provide day-to-day regulation of brokers and dealers operating in the over-the-counter securities markets and to have the Commission supervise NASD. The 1973 Securities Industry study, however, concluded in part that

> "* * * major regulatory problems in the securities industry have not, by and large, been the result of the SEC's [Securities and Exchange Commission's] lack of authority but rather of its apparent lack of the will to use the powers it already has."

In a 1977 address the current Chairman of the Commission stated:

> "The role of the Commission is to provide oversight, that is, to goad and to prod as necessary to assure that the self-regulatory bodies are responsive to the changing needs of society, of investors, and of the public. * * * self-regulatory bodies have been slow to change, slow to respond, slow to acknowledge the need for change * * *. The expectation is that the Securities and Exchange Commission should exercise an aggressive oversight function."

Our limited review indicates that the Commission staff is not aggressive enough in bringing inspection oversight problems and possible solutions to the attention of the Commission for decisions. Insofar as the staff could recall, in the past several years only six memorandums relating primarily to inspection oversight of NASD have passed through channels to the attention of the Commission. Summaries of the two most recent memorandums follow.

<u>August 1977</u>. The Office of Self-Regulatory Oversight sent the Commission a memorandum detailing weaknesses encountered in NASD district offices in such areas as disciplinary procedures, review of customers' complaints, and referrals of possible serious violations to the Commission's regional offices. The memorandum did not relate the adequacy of NASD responses to the seriousness of the weaknesses.

The memorandum was purely informational and contained no action recommendations.

January 1978. The Division of Market Regulation sent the Commission a memorandum expressing disagreement with NASD regarding its proposed 1978 budget, particularly its provisions for NASD's staff of examiners. The memorandum asked the Commission to authorize the Commission staff to send NASD a letter expressing doubt about the adequacy of the examiner staff and explaining the terms under which the Commission would permit NASD's fee and assessment schedule to go into effect.

In each of the memorandums Commission staff informed the Commission of a problem area and obtained Commission acquiescence--to no action in one case and to minimum action in the other--without briefing the Commission on alternative actions that could be taken.

Four other memorandums sent to the Commission discussed the results of several oversight inspections made during 1972 and 1973. All four memorandums were informational and contained no recommendations or suggestions for Commission action.

The branches involved in inspection oversight of NASD are organizationally separated from the Commission by intervening office and division levels of management. This organizational distance means that the working staff within the branches generally deals with the Commission indirectly through intermediate levels of management.

The Commission has not issued guidelines which would assist the working level staff and intermediate management in keeping the Commission appropriately informed and in carrying out its policies. In our discussions with Commission officials we were told that guidelines such as we suggest are not necessary because the agency operates informally and that working level staff has access to and meets with the Commission at appropriate times. The officials stated there is a general unwritten guideline that they convey new and novel issues to the Commission.

CONCLUSION AND RECOMMENDATION

We question whether in a 2,000 person agency, written guidelines can be foregone, on grounds that working level staff will always have full access to top-level management and will be able to discuss their problems directly with the Commissioners.

It is understandable, in the absence of adequate feedback information on Commission attitudes and viewpoints, that the staff would not deal aggressively with NASD officials and would avoid taking action, in the words of the Chairman, "to goad and to prod" NASD. We believe that more explicit guidelines covering areas of staff responsibility for inspection oversight could be useful. Such guidelines might include the

--nature of problems which should be handled by the working level staff and by intermediate management,

--types of problems and agreements which should be handled by the Commission,

--special instructions to govern oversight activities in areas where serious disagreements exist with NASD,

--procedures to govern the disposition of inspection findings with NASD, and

--actions to be taken if the Commission staff is hindered in obtaining full and prompt access to records.

We recommend that the Commission issue guidelines to assist the staff assigned to NASD oversight. These guidelines should require the preparation of a written record and provide criteria on when problems on which satisfactory progress is not being made are to be submitted to higher levels within the Commission for resolution. The guidelines should also aim at reducing the use of no-action information memorandums by requiring that memorandums sent to the Commission about problem areas include a discussion of possible actions and, if appropriate, a recommended action.

CHAPTER 5

COMMISSION'S INSPECTION OVERSIGHT

SHOULD BE BROADENED

The Commission's inspection oversight is heavily concentrated on the operations of NASD district offices. Inspection information obtained at the districts includes how the district business conduct committees are constituted, the adequacy of examiners' reviews of brokers and dealers, size and age of customer complaint files, and reasonableness of penalties imposed for rules and law violations. This is a compliance approach to oversight directed toward telling the Commission about the continuous, routine administration of the district offices and NASD members' compliance with administrative rules and Federal securities laws. It is not an approach which would yield the best potential for developing wide-ranging insight into emerging problems.

There are 13 NASD districts. The number of general and special inspections made by the Commission staff at NASD district offices and headquarters were as follows:

	Fiscal year				
	1975	1976	1977 (note a)	1978 (note b)	Total
General inspections	6	6	8	3	23
Special inspections	-	2	3	2	7
Total	6	8	11	5	30

a/Contains 15 months' activity due to addition of a 3-month fiscal year conversion period.

b/Includes only the first 10 months of fiscal year 1978.

Of the 14 reports on inspections made in fiscal years 1975 and 1976, 7 could not be located by the Commission staff. No report had been prepared for another inspection. The reports for two additional inspections were still in draft form although the inspections had been completed 6 and 10 months previously.

Only 4 of the 30 inspections pertained to headquarters' responsibilities. Until recently, inspections were conducted by one or two Commission staff members spending 1 to 3 days at a NASD site. For the last five inspections (made in late 1977 and early 1978) three to nine staff members were assigned, each member averaging about 2-1/2 days at the site.

The Commission's 1963 Special Study commented with respect to the then prevailing narrow operational view of oversight:

> "There appears to be need for stronger emphasis in areas of ultimate Commission responsibility such as broadly surveying market developments and regulatory needs, expressing standards and interpretations for the guidance of the industry in respect of areas of uncertainty or change, and supervising and evaluating the activities of the self-regulators."

We believe the need still exists for a broader view in the Commission's inspection oversight of NASD. The inspection oversight staff focuses heavily on individual NASD district operations and does little to analyze overall district operations or its activities over a longer time period. The inspection oversight staff has reviewed only a few NASD headquarters activities. An inspection "presence" at NASD headquarters would provide Commission staff with broader knowledge than is available at the district offices regarding operational trends, the potential of NASD management systems, and NASD decisions being made about anticipated changes in the market.

It is apparent from the inspection oversight staff's focus that it views the over-the-counter market in a narrower perspective than does NASD. The staff is therefore unlikely to be first to identify conditions calling for new regulatory responses. The staff is unlikely to provide the Commission with guidance on questions such as: What additional preventive programs should NASD be introducing to reduce the incidence of rules and law violations and increase investor protection?

In discussing our findings, Commission officials said that they develop a broad view of oversight by other means, for example, a recent consulting contract, a task force study on options, and the making of securities rules. There are difficulties with this viewpoint. Services being provided under the consulting contract (for definition and design of a market surveillance system) do not serve as an alternative means of providing broad oversight of NASD. The options study is an indirect approach to providing oversight and does not argue effectively for keeping inspection oversight narrow. A proceeding to make a major securities rule, for the purpose of instituting uniform net capital requirements, was initiated in 1975 after the collapse of securities firms and consequent losses to investors. This example of rulemaking would tend to support giving a broader role to inspection oversight as a means of identifying problem areas earlier.

CONCLUSION AND RECOMMENDATION

The Commission's current inspection oversight keeps it informed about what NASD is doing at a district operating level. That oversight, however, is too narrow to make its full contribution towards developing the Commission's policy perspective in areas such as raising industry's ethical standards, providing new investor protections, or devising better ways of measuring self-regulatory performance.

We recommend that the Commission develop an inspection oversight program which reaches beyond what NASD is doing to what it might be doing to promote the public interest. In this respect, headquarters' view of oversight might be improved if some Commission staff members were relocated to work at NASD headquarters, as opposed to their present location at Commission headquarters.

CHAPTER 6

ADDITIONAL PROBLEM AREAS

IN THE COMMISSION'S ACTIVITIES

We observed additional problem areas in the Commission's oversight of NASD. Although we could not fully explore these matters because of the limited time available to complete our review and report to the Subcommittee, we believe the effectiveness of the Commission's oversight is being impaired in the following areas, which are briefly summarized.

MAKING USE OF NASD INTERNAL REVIEW INFORMATION

The Commission staff performs its inspection oversight without reviewing the work of NASD's internal review group. The group's work, which includes examinations of NASD district offices and "autopsies" of failed brokers and dealers, is relevant to the Commission's inspection oversight. Without awareness of problem areas identified by the NASD internal review group, Commission staff may be directing its oversight efforts to second-priority areas or duplicating NASD findings.

TAKING NOTE OF MINUTES OF NASD TOP-LEVEL MEETINGS

Most important matters affecting the over-the-counter market and NASD self-regulation should, sooner or later, receive the attention of NASD's numerous national committees and its Board of Governors. The Commission staff, however, does not obtain this information on a timely basis by regularly reviewing the minutes of meetings of the committees and the Board.

ESTABLISHING AND USING INSPECTION PLANS

The Division of Market Regulation has inspection plans only in the loosest sense. For the most part, the inspection plans are barebone lists of offices to be visited. For example, one fiscal year plan consisted of eight words, seven of which were city names.

We were told that because of a lack of staff the plans often are not followed. A plan, for example, covering a

9-month period called for 12 specific inspections but only one had been made during the first 7 months of this plan. Furthermore, the Commission has reviewed only four headquarters activities of NASD in recent years.

We believe efficient and effective inspection oversight hinges in part on the preparation of adequate inspection plans and substantial adherence to the plans.

COMMUNICATING INSPECTION FINDINGS TO NASD

Commission staff making inspections of NASD district offices and NASD members do not prepare findings reports for transmittal to NASD. Rather, the staff writes internal memorandums to superiors within the Commission. Consequently, inspection findings are communicated to NASD through meetings and (sometimes) confirming letters.

Officials of the inspected district offices may or may not be present when the Commission staff discusses its findings with NASD headquarters officials. In our opinion, NASD district officials who, as a result of Commission inspections, are charged with deficiencies should be given the opportunity to discuss their actions with the inspectors. This does not necessarily happen under current procedures.

It is difficult to determine from Commission records exactly what findings were discussed with NASD officials and the manner in which they were discussed. The informal procedures used to communicate findings leave scant record of actions promised or taken by NASD and thereby diminish the force of Commission oversight.

FOLLOWING UP ON NASD CORRECTIVE ACTIONS

Commission staff actions taken to follow up with NASD on inspection recommendations are generally informal, undocumented, and incomplete. Also, the corrective actions taken are not verified until the next inspection is made. Lack of followup may contribute to the same type of deficiencies continuing to exist in subsequent inspections.

CONTROLLING DELAYS IN PROCESSING COMPLAINTS

Delays that occur while NASD processes a complaint and the Commission reviews any disciplinary actions imposed may permit the broker or dealer to continue questionable operations long after the violation is detected.

We reviewed 42 complaints filed at a district office during a recent 3-1/2 year period. Two to 24 months elapsed in the 29 completed cases from the time the district notified the member of the complaint until the case was finally adjudicated by NASD or the Commission. Three to 12 months had lapsed on the 13 cases still open. Our analysis suggests that, while many delays reflect the need to observe the minimum requirements of due process, some time lapse represents avoidable delay, as shown by the following examples, and could be eliminated.

An individual promised to provide the district business conduct committee with additional information to prove his innocence. Eight months passed without the information being provided. The committee finally acted on the complaint without the additional documentation.

In another case, the district business conduct committee lacked adequate information to hold a substantive hearing. The committee asked an individual for additional information. The individual delayed the hearing for 10 months without providing complete information.

Hearings in several instances were held shortly after the district business conduct committees held their quarterly meetings. Final actions on the complaints could not be taken until the committees held their next meetings about 3 months later.

RECOMMENDATIONS

We recommend that the Commission take steps to

--obtain information on NASD internal reviews and minutes of meetings of committees and the Board of Governors,

--prepare and execute more meaningful inspection oversight plans,

--revise its procedures for conveying inspection findings to NASD and for following up on corrective actions taken by NASD, and

--study Commission and NASD procedures for processing complaints with the objective of reducing or eliminating avoidable delay.

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