Draft of September 21, 1938

Part II

Part I of this report has narrated the chain of events which led up to and attended the eventual failure of Richard Whitney & Company, followed as it was by the losses to customers resulting from Richard Whitney's misuse of their funds and his embezzlement of their securities. It has described the disciplinary action taken by the New York Stock Exchange when its responsible officials became aware of Richard Whitney's defalcations. Lastly, Part I has also described in detail the limited facilities provided by the former rules of the Exchange and by the practices and policies of its former management for the detection of members' insolvency and misconduct. The historical facts of this case stand as a clear demonstration that a real measure of improvement and reform of present methods of the brokerage business is an immediate necessity. These facts also illustrate why the easy perquisites of a private club are not consistent with the high standards demanded of a public institution such as a national securities exchange.

After the events described in Part I had transpired, the administrative machinery of the Exchange was reorganized and a new management installed. That new management has been working cooperatively with this Commission in an endeavor to raise and to strengthen the standards of brokerage practices of the Exchange's members and to eradicate those malpractices which Richard Whitney pursued without hindrance for almost twelve years. No matter how the present system be improved it cannot be made "crook-proof". Dishonest fiduciaries can ever find some way to betray their trust. Regulation, whether by the Exchange or by government, can never abolish that risk. Nor can it prevent financial failures. But it can and must provide effective deterrents to those abuses and malpractices and effective machinery to facilitate their detection. The severity of the impact of failures and dishonest practices on the public and on other members of the Exchange must be thus tempered. Regulation which promises more than that would be misnamed; regulation which did not conscientiously undertake to minimize those risks would be but an empty gesture.

Accordingly, Part II of this report will explain the character of regulation which seems to us necessary. Its full-fledged development will of necessity be an evolutionary one. But many immediate concrete steps are possible. In fact some have already been taken or are now proposed by the new management of the New York Stock Exchange and by the Commission. Some of these are purely intermediate measures; others are permanent. But these immediate steps constitute a sound commencement for the building of an Exchange mechanism which will provide more adequate protection than is present in any securities market today.

The failure of Richard Whitney & Company, like other brokerage and dealer insolvencies, illustrates the dangers and risks which arise from the present combination (1) of the brokerage and banking business; and (2) of the brokerage and dealer business. First, as to the brokers' banking functions: Their banking business, despite its size and importance, has heretofore been subject to little regulation and to no real supervision by the exchanges. It is still neither regulated nor supervised as a banking business by the Government, state or federal. The extent of the banking activity of the broker, increasing with the growth of public security holdings, has resulted from the broker's acceptance of deposits of customers' funds and securities and from his loans of his own and other's funds and securities. Such loans, of course, are usually made by brokers to other customers to enable them to carry margin accounts with him.

The broker also receives and controls customers' fully paid for securities which have been left with him for safekeeping, as well as securities which constitute excess collateral not needed to secure his customers' margin accounts. The broker likewise retains even more extensive powers of control over all customers' margin securities, which under present practices, are repledged with various banks as colatteral for the broker's bank loans from which the broker in turn loans to his customers the funds necessary for their margin accounts. The importance of the banking business now conducted by brokers is illustrated by the fact that, as of May 31, 1938, member firms of the New York Stock Exchange alone held deposits of customers' cash in the form of free credit balances aggregating approximately $196,000,000. The total market value of all customers' fully paid or excess collateral securities[1] held by brokers is not yet definitely known. Nevertheless it has been conservatively estimated to be many times greater than the amount of customers' free credit balances.

Though brokers carry on banking functions for their own profit, they also assume a fiduciary obligation to their customers, whether debtors or creditors. Despite the high degree of this fiduciary obligation, practices in the handling of customers' funds have developed which are both lax and in disregard of the ordinary standards of trusteeship. Too often customers' free or excess collateral securities have not been segregated from the securities of the firm, its partners or from securities held on margin for other customers. The existence and proper earmarking of certificates held for safekeeping normally have been left unchecked or otherwise unverified by the Exchange's auditors. In cases of insolvency or financial stress it has even been found that brokers, as did Richard Whitney, have sometimes used these securities to collateralize their own business loans to tide them over a crisis in the futile hope of regaining past losses.

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[1] Securities not necessary to collateralize the customer's account.

Customers' free credit balances are regularly subjected to even greater hazards. The usual practice has been to commingle customers' funds with those of the firm and to use them for whatever the daily demands of the business may require. The bank balances of member firms of the New York Stock Exchange are normally far below the total amount of customers' free credit balances.[1]

To a lesser degree the same dangers exist in connection with the handling of customers' securities and cash which are pledged with brokers as security for margin transactions. Despite rules of the Exchange to the contrary, the margin securities of customers may be rehypothecated with banks in excessive amounts which bear no relation to customers' indebtedness to the broker, or may be so commingled with the securities of the firm, its partners or of other customers as to subject their owners to unjustifiable hazards. Customers' cash payments to brokers for the purchase of securities, either outright or on margin, may likewise be kept by brokers and used for their own benefit in the same fashion as the customers' free credit balances. This is true even though such "bucketing" of orders is strictly prohibited by rules of the Exchange as well as by the criminal law.

These risks to customers inherent in the merging of a banking business with the agency functions of a broker are accentuated by the absence of any real financial supervision. The New York Stock Exchange, shortly before the Whitney episode, inaugurated a requirement that all

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[1] ABSTRACT FROM REPORTS OF NEW YORK STOCK EXCHANGE MEMBER FIRMS TO THE FEDERAL RESERVE BOARD SHOWING THE RELATION BETWEEN TOTAL CASH IN BANKS AND CUSTOMERS' FREE CREDIT BALANCES.

Date	Number of firms Reporting	Cash (000,000 omitted)	Free Credit (000,000 omitted)	Difference (000,000 omitted)
5/31/38	259	$168	$196	$28
12/31/37	283	187	226	39
6/30/37	290	172	216	44
12/31/36	288	202	277	75
6/30/36	291	183	228	45

members and member firms, regardless of the character of their business, must file financial statements with it at least twice a year. This, of course, represents only a small and an initial step towards regulation of brokers' financial condition comparable to that which has long been extended over state and national banks, trust companies and insurance companies.[1]

Second, as to the brokers' business as a dealer: Some exchange houses do nothing but a brokerage business. More frequently, however, brokerage houses also trade for their own account and engage in the underwriting business. This combination of functions entails further risks. As we have earlier said:

> "In addition to executing brokerage orders for customers, commission houses may perform a diversity of functions. They may act as principals in underwriting, in the primary and secondary distribution of securities, and in trading operations for firm account. They may serve as fiduciaries in furnishing investment advice to customers, in conducting discretionary accounts and in managing investment trusts. These interrelationships may be further complicated when such firms extend credit to their customers, hold customers' securities in pledge or hold customers' free funds on deposit; or when partners of such firms trade for their own account or act as directors or officers of corporations whose securities are listed on exchanges.
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> "The financial interests of a commission house, the activities of which are thus diversified, may run counter to the best interests of those for whom it acts as agent. Such a commission house may solicit brokerage customers to purchase securities which it has underwritten or is distributing or in which it has a position or an option. In furnishing investment advice, its recommendations may be colored by its security commitments. It may sell its own securities to accounts over which it has discretion. Substantial participation in underwriting or distributing operations or excessive trading for its own account may impair the solvency of a firm, thereby jeopardizing the securities, equities, and credit balances of customers. A commission house managing an investment trust may use the trust as an outlet for issues which the firm has underwritten or is distributing; or it may employ the buying power of the trust to maintain the price of such issues.

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1 See Rule 831 of the Rules of the Board of Governors adopted May 16, 1938.

> "Undoubtedly, abuses incident to those multiple relationships are held in check by the standards of business conduct prevailing among reputable commission brokers. Practices on the part of a commission house which are detrimental to the interests of its brokerage customers would appear, in the final analysis, to be opposed to the dictates of enlightened self-interest. Nevertheless, such abuses have not been uncommon in the past."[1]

Not only do dealer functions, when exercised by brokers, threaten the best interests of customers, but they superimpose additional financial hazards upon the unregulated banking business as now conducted by stock exchange firms and other brokers. Speculation by brokers or brokerage firms for their own account as well as their purchase of blocks of securities for primary or secondary distribution – the normal causes of brokerage failures – directly threaten the brokers' capital essential to the safe handling of their customers' affairs, funds and securities. Theft and embezzlement of customers' funds or securities are usually but the aftermath of a course of over-extension and over-commitment invited by permitting brokers to engage in trading or underwriting activities for their own account.

In spite of the risks to customers inherent in the combination of brokerage, banking and dealer functions, the record of exchange houses in terms of financial failures has been an exceptionally good one. But the fact that insolvencies have resulted but infrequently is no excuse for perpetuating the present system. The impact on the public, and on the exchange members themselves, of those financial failures which have occurred has been serious. The very existence of a system which permitted Richard Whitney to proceed unmolested for almost twelve years has a corroding influence on public confidence in the integrity and safety of that system. Existence of such confidence is a prerequisite to healthy securities and capital markets – the keystones of our industrial economy. To that end, the new management of the Exchange has

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1 See pp. 3-4, <u>Report on the Possibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker</u>, Securities and Exchange Commission, June 20, 1936. The similar abuses in the over-the-counter securities markets which may result from combining broker and dealer activity are reviewed at P. 75 of this Report.

recognized the need for a thoroughgoing reappraisal of existing practices. In cooperation with this Commission, it has agreed to initiate a number of related measures designed to reduce the risk of loss to customers due to the laxities emphasized by the bankruptcy of Richard Whitney & Company.

This inauguration of reform measures by the Exchange is in harmony with the philosophy of self-regulation which the Commission has championed. Furthermore, the provisions of the Securities Exchange Act of 1934 clearly imply that in certain respects this Commission should encourage the national securities exchanges to take the initiative in their own improvement. Thus, under Section 10(b) of the Act the Commission may request the exchanges to supplement their own rules upon a number of matters including "safeguards in respect of the financial responsibility of members". Formal coercive action can be taken by the Commission pursuant to those provisions only after an exchange has itself failed to take the necessary steps. Accordingly, the Commission has sought so far as possible to play a residual role in the internal regulation of exchanges. This policy is reflected in the following program of the Commission and the Exchange for complementary measures for the protection of customers.

A TRUST INSTITUTION TO SAFEGUARD CUSTOMERS' FUNDS AND SECURITIES

Several proposals have been advanced to minimize the many risks to customers which now result from brokers' insolvencies, and to reduce the hazards of brokers' misuse or theft of customers' funds and securities. Conspicuous is the suggestion that national securities exchanges establish trust institutions within their vicinities which will assume all of the custodial duties now assumed by brokers as an incident to their banking business. Obviously a broker carrying margin accounts, and hence loaning money to his customers, is entitled to collateral security for the repayment of that indebtedness. But equally obvious is the fact that a broker should not be entitled to use customers' pledged securities, much less their free credit balances, to finance his own business or other accounts. A trust institution to hold customers' cash and their margin and fully paid securities would largely preclude the possibility that a broker could convert his customers' property to his own uses in violation not only of the rules of the Exchange and of this Commission, but also of the applicable criminal law.

In its relation to members of the New York Stock Exchange the suggested trust institution would, when fully organized, assume the entire burden and responsibility of holding customers' cash and securities, of carrying customers' accounts, of receiving securities and cash directly from customers and, conversely, of making disbursements of cash and deliveries of securities only to or upon the order of customers.

It has been proposed -- and on the basis of the preliminary canvass the proposal appears wholly feasible -- that such a trust institution holding all the securities which would otherwise have been left in the hands of the member brokers of the New York Stock Exchange, would deliver directly to loaning banks such securities as might be needed to collateralize brokers' loans. However, the trust institutions would surrender customers' collateral securities only upon receipt by it of the loaned funds. Thereafter, the trust institution rather than the individual brokers, would be responsible for proper application of borrowed funds to the accounts of the customers. Brokers' out-of-town business could be handled through a system of correspondent banks or trust companies located in regions from which customers' orders arise. Presumably other trust institutions established by other exchanges would be included as correspondents. The bonding of all officers and employees of the trust institution would protect against the final possibility of mishandling of the customers' cash or securities deposited with it.

ADVANTAGES OF A TRUST INSTITUTION AS DESCRIBED ABOVE

The manifold risks to customers, inherent in the brokerage business as now conducted, in nearly all instances could be greatly reduced if not wholly obviated by a trust institution to act as the cashier and depository of member brokers. Customers whose funds and securities are held by the trust institution would thus be more adequately protected against the occasional case where their own brokers improperly rehypothecate or embezzle their securities or misuse their free credit balances. Such a trust institution would also give protection to customers against the greater and more varied risks now attendant upon brokers' insolvencies. For, with the customers' free credit balances and securities, both margin and safekeeping, intact in the hands of the trust institution, financial crises in the affairs of member firms or their partners could not jeopardize their customers.

The risks of possible criminal misconduct by a broker are of course but slight in comparison with the more varied hazards now inevitable in the event of a brokerage failure. The collapse of a modern brokerage firm under a system which permits its assets to be intermingled with customers' claims and property and thus to be subjected to the liabilities of the broker both as a banker and as a dealer for his own account, creates a situation of the greatest legal complexity. A bankrupt brokerage house instantly becomes a hotchpot of rival and conflicting claims. Banks holding customers' securities as collateral for the broker's defaulted loans seek to realize in full, often to the detriment of customers. The claims of other classes of creditors must also be recognized. Owners of safekeeping securities must seek, usually with rather less than greater success, to trace and reclaim their property. Other free securities of customers, as well as excess collateral securities, often cannot be located. They may have been sold by the broker to satisfy other creditors. Or they may have been commingled with his own securities and repledged to secure new loans. Customers' claims for the repayment of free credit balances, as well as their equities in margin accounts, are normally diluted by the claims of other creditors who are not brokerage customers. Thrown into this welter of opposing rights and priorities, customers' securities may be regained or payment of at least a part of their claims obtained only at the cost of legal fees commensurate with the intricacy and expense of brokerage receivership or bankruptcy proceedings.

The trust institution, a single proposal, would give a full measure of protection against this costly confusion. Fully paid or excess collateral securities would, of course, be earmarked for their owners and kept segregated in the vaults of the institution. No risk of loss through their sale by the broker or through commingling with the securities of others as collateral for brokers' loans could be entailed. "Tracing the res" would no longer be the difficult and often the impossible task which it now is. Similarly, free credit balances deposited in an earmarked bank account by the trust institution rather than with the customer's broker would be comparably protected against claims by other creditors of an insolvent broker. Customers' equities in margin accounts, as well as their margin securities, would also be isolated from the affairs of the insolvent broker. For, with the trust institution responsible for the proper application of brokers' loans when collateralized by customers' securities, there would be ample assurance that those funds would be used solely to finance customers' margin accounts. Hence, their margin securities would always be available to customers upon payment of their debit balances. Thus the rights both of margin and cash customers would be protected, since their securities would at all times be traceable and their balances, accurately reflected in their individual accounts as kept by the trust institution, would not be reachable by other creditors.

The trust institution's safeguard of customers against the hazards and the legal confusion which result from a brokerage insolvency is but the more obvious of its potential benefits. Of equal importance is the ability of such an institution to prevent its participating brokers from self-entrapment in the many situations which may now be contributing factors to the possible eventuality of financial failure and defalcation. To remove the causes of a brokerage failure is the best protection against the dangers to customers which normally become imminent only when that crisis has been reached. In an attempt to remove some of the more common causes of a broker's insolvency, the New York Stock Exchange and this Commission have resorted to such regulatory mechanisms as are now available. Accordingly, a joint program covering some fourteen regulatory measures has been evolved with which partially to meet the existing sources of peril. This program, which will later be described in some detail, of course requires a multiplicity of rules, both of the Exchange and of the Commission.

The Exchange will seek, by its own rules, to reduce the extent to which customers are now directly affected by the dangers of the dealer and the banking business as presently carried on by its member brokers. To minimize customers' losses from brokers' insolvencies brought about by their speculative, trading or underwriting ventures, the Exchange will encourage the divorcement of a broker's capital as such from his assets and liabilities as a dealer for his own account. To this end margin trading by member firms doing a public commission business will be prohibited. The present freedom of member firms doing a brokerage business to engage in security trading and underwriting for their own account will be sharply curtailed. Most brokerage firms may find it necessary to isolate those risks in an affiliated dealer corporation, the possible losses of which may not directly jeopardize the safety of their brokerage customers.

The Exchange will take further steps to prevent the dissipation and loss of brokers' capital – the cushion essential to protection of customers – by increasing the requirements for capital which must now be met by its member brokers. The maintenance of a conservative ratio of capital to indebtedness will be policed, so far as possible, by the required filing of monthly financial statements of its members, by a requirement for periodic audit by independent accountants and by surprise examinations to be made by the Exchange's own auditors. The problem of financial safety will also necessitate further rulings that so-called special loans made or obtained by its members must be forthwith reported to the Exchange. This latter provision, of course, will tend to prevent reckless and excessive borrowing such as that which temporarily forestalled the collapse of Richard Whitney & Company, but which so greatly increased the severity of the eventual debacle. The related question of members and partners speculation and margin trading to the detriment of their firm's and their customers' safety must also be faced and answered by the Exchange. It may well become necessary to prohibit all partners of member brokerage firms from trading on margin.

The impairment of brokerage capital presents an even broader problem to this Commission which, under the Securities Exchange Act of 1934, is empowered by rule to require the safe handling of brokerage capital not only by members of exchanges, but also by all brokers or dealers doing a business through the medium of exchange members.

The present practice on the part of brokers to require all customers to sign blanket agreements under which, generally speaking, customers' securities may be treated by a broker for many purposes as though they were his own, likewise creates problems which must be answered by rules of the Commission. This Report has already shown how the commingling and repledging of customers' securities, whether paid for in full or whether held in margin accounts, in order to obtain funds for the brokers' own uses, may lead first to over-extension and later to financial collapse. To prevent brokers from using their customers' securities to finance their own trading activities, the Commission will be required to limit repledging of customers' securities solely to the extent necessary to finance their accounts. The Commission's rules will further require that customers' securities must at all times be kept separate from those of the firm or those of any person other than a customer.

The inadequacy of the books of Richard Whitney & Company to reflect its true financial condition and to preserve a clear record of the securities and balances of its customers has been described earlier. To meet these and similar dangers, the Commission proposes to promulgate rules under Section 17 of the Act which will standardize the bookkeeping practices of members of exchanges as well as of other brokers. These rules will require the maintenance of books and records adequate to disclose the financial condition of a broker and adequate to safeguard his customers. Furthermore, under the statute, these records will be subject to examination by the Commission.

These abuses which must be met and the remedies which are proposed will be hereafter described in greater detail. Sufficient here merely to suggest them and to indicate the general scope of the program for joint action by the Exchange and the Commission which is necessary to bring a further measure of safety to the present conduct of the brokerage business. This program for joint regulation is necessarily complex. The various provisions to be adopted by the Exchange and by the Commission do not all dovetail. Just as there are some interstices in this regulatory program through which the shrewd thief may slip, so also there are occasional duplications. Inevitably such a regulatory structure will have its deficiencies. It must, therefore, be recognized as a temporary stop-gap designed to fill as best it can the immediate needs for customer protection. The trust institution which has been proposed would, when in full operation, go to the root of these and many other potential dangers to brokers' customers and to brokers themselves. Through its vigilance over the funds and securities of customers held by it subject to their order, the trust institution would assure that customers would not be subjected to the multiple risks which brokers may choose to incur as dealers, traders or underwriters for their own account. Such a trust institution would prevent the ever present hazard of over-extension by brokers which is now encouraged by the freedom with which customers' money and securities can be used by the broker for his own purposes. Restricted to his own funds and to his own securities, the broker would be less apt to tread so far into the dangers of speculation as he is now able to venture as a result of his powers to use customers' funds and property for his own benefit. The trust institution would in large measure render the financial condition of the broker, either as a broker or as a dealer, immaterial to the safety of his customer. Thus, the infinite variety of present dangers to customers may be met with but a single far-reaching proposal, rather than by the adoption and enforcement of a multiplicity of regulations and rules which in the absence of the trust institution are necessary if the public trust of the Exchange and of this Commission is to be requited.

Furthermore, the legitimate self-interests of member brokers and others in the trade would be advanced through their adoption of a full-fledged trust institution. Its mechanism would reduce the clearing and settlement of transactions, now effected by the costly process of physical delivery of comparison slips, securities and remittances, to a mere matter of bookkeeping entry. The burden of physical deliveries, by messenger or by mail, and its consequent expenses should long since have become obsolete in New York as in certain other financial centers of the world. The trust institution holding in its own vaults or under its control all of the securities and funds involved in the daily transactions executed by member brokers of the Exchange, could carry out the functions of comparison, clearing and settlement through appropriate entries in the comprehensive records which it would maintain. The economics of clearance alone should render the institution largely self-sustaining. Of even greater importance would be the many economics resulting from the centralization of the extensive bookkeeping work now carried on in the "back-office" of each individual member firm. Consolidation of this function -- which is little if ever seen by the public and which produces no direct revenue -- into a single organization performing the bookkeeping, clearing and custodial functions of all the member brokers, would, through its economy, render the trust institution a major benefit to the Exchange's membership, even aside from its effect upon public confidence.

The Commission recognizes that fulfillment of the proposal to establish a comprehensive trust institution such as that outlined above will constitute a long term program. Nevertheless, it is felt that the initial steps toward such an institution should be promptly taken. There should first be established a central securities depository to serve as a nucleus around which the trust institution can be built. It is contemplated that the central depository should, at the outset, act as an institution with which brokers may deposit customers' securities and cash. Such a depository, in addition to performing these custodial duties, would supplement the clearing and settlement functions now performed by the Stock Clearing Corporation.

By letter dated ___________________________, the President of the New York Stock Exchange has taken the following position relative to the establishment first of a central securities depository and, later, of a comprehensive trust institution:

Realizing that a central depository for securities is but the commencement of a broad program and, absent a comprehensive trust institution, that the hazards inherent in the present confusion of banker, broker and dealer functions will continue, the new management of the New York Stock Exchange has taken immediate action upon several other proposals designed to afford at least an interim protection against some of those hazards.

It has long been customary for all securities exchanges to require that one who would represent the public in their markets must have sufficient capital to transact his business with safety. However, sufficient capital has been a loosely defined concept often applied with commensurate laxity. Certain requirements for the maintenance of capital have been adopted and enforced by most national securities exchanges through the use of the questionnaire system, the object of which has been the detection of any impairment in working capital. Such measures are basically sound. They serve to require that one who embarks upon the brokerage business shall possess some degree of financial responsibility and to uncover any diminution of the initial working capital. The present capital requirements do not, however, remove the most important single cause of brokers' insolvencies, losses resulting from speculation or transactions effected for the brokers' own accounts.

SEPARATION OF BROKERAGE CAPITAL FROM LIABILITIES AND COMMITMENTS INCURRED BY A BROKER ACTING AS A DEALER FOR HIS OWN ACCOUNT.

Brokerage failures such as that of Richard Whitney & Company, in nearly all cases, can be traced directly to the losses incurred through the employment of firm or partners' capital in losing ventures not connected with the performance of the brokers' function. Normally these losses have represented the disastrous effects of security trading either for firm or partners account. Often these losses have resulted from unsuccessful security distributions under underwriting commitments. Both the Exchange and the Commission have accordingly concluded that it is essential, if brokerage customers are to be protected, that as a minimum the dealer business in which a brokerage firm may engage for its own account must be divorced from the assets and liabilities of the brokerage business and from the funds and securities of customers. The New York Stock Exchange has therefore proposed to prohibit margin trading by its member firms doing a brokerage business and to permit its member firms to establish affiliated dealer corporations separate from their brokerage business. It is contemplated that through this mechanism the broker's capital essential to the safe conduct of his commission business can be isolated from the trading, speculating or underwriting risks which he may undertake for his own account. Furthermore, if the flow of funds from the brokerage firm to the dealer corporation is rigidly controlled, failure of the affiliated dealer corporation would involve neither customers' funds or securities nor the capital of the brokerage firm. Nor would the creditors of the dealer corporation have any rights adverse to the customers of the member firm.

The statement of the New York Stock Exchange reads as follows:[1]

> " Segregation – After January 1, 1939, no member firm doing a general business with the public may carry underwriting, security, or commodity positions for its own account or for the account of any of its general partners unless such securities or commodities in effect are paid for in full. The formation of affiliated companies with stockholders' liability limited will be permitted for the purpose of segregating assets and liabilities arising out of business done for firms' own account or for the accounts of their general partners from the assets and liabilities arising out of firms' business for their customers."

This program of so-called segregation is not segregation in the broad sense of the word. It is only utilization of the corporate device to afford customers insulation from some of the financial hazards which result from combining a brokerage business with a dealer business. It is aimed solely at those transactions which may impair the solvency of a brokerage firm, thereby jeopardizing the securities, equities, and free credit balances of customers. It does not touch the other phases of segregation of the functions of the broker and the dealer which many deem to be of equal or greater importance. Since under this new system, the owners of the firm and the owners of the corporation will be substantially identical, other disadvantages from the viewpoint of customers will persist as freely under the proposed system as under the old one. These disadvantages arise from the multiple financial interests of a commission house. As we have earlier stated:

> "* * * Such a commission house may solicit brokerage customers to purchase securities which it has underwritten or is distributing or in which it has a position or an option. In furnishing investment advice, its recommendations may be colored by its security commitments. It may sell its own securities to accounts over which it has discretion."

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1 The proposed ruling of the Committee on Member Firms relative to such affiliated companies is set forth in Appendix A of Part II of this report.

We take this opportunity to stress that the Exchange's program does not deal with those aspects of the problem. We are here concerned exclusively with the problem of safeguarding the solvency of brokers.

The benefits of such a separation of brokerage capital from dealer capital might be completely dissipated if the flow of funds from the brokerage firm to the affiliated corporation were not carefully restricted. Accordingly, the following safeguards will be set up.

The Exchange's program, increasing the capital requirements applicable to its members, will provide that any loans which the brokerage firm may make to its affiliated dealer corporation must in all cases be treated as a reduction of its brokerage capital. Consequently, no brokerage firm will be able to loan its funds to its dealer affiliate unless it is in so strong a financial condition that it can do so without increasing the ratio of its indebtedness to its capital beyond the maximum limit to be set by the new rules. Hence, only such excess funds may be used by an affiliated dealer corporation as are not necessary to the safe conduct of the brokerage business and to the protection of its customers. The Exchange will also require that all loans by member firms to affiliated corporations must be immediately reported to it regardless of whether they are collateralized and regardless of their amount.

CAPITAL REQUIREMENTS IN RESPECT OF MEMBER BROKERAGE FIRMS

As shown by the Whitney failure a broker's capital which should stand as protection to his customers has been a shifting amount. Obviously, a broker's capital should be devoted first of all to the needs of his brokerage business, including the financing of his customers' margin accounts. However, brokers' capital has regularly been employed to a varying extent in the firm's own speculative trading. Consequently, capital has normally included such items as the equity values in partners' and the firm's own trading accounts. Capital, which depends upon the market value of securities often highly speculative in character, varies from minute to minute with the price fluctuations in the market. Capital so constituted is constantly exposed to the risk of trading losses in partners' and the firm's accounts. Then, too, it is subject to withdrawals by partners at any time. It may, on the other hand, become frozen as did the capital of Richard Whitney & Company by placing all or most of it in one security. Such loose handling of capital is in contradiction of the member's public responsibility since it may so easily result in undermining his financial condition.

The Exchange and the Commission, therefore, realize that no program for the protection of buyers or sellers of securities can be complete unless it serves to preserve adequate capital for all member firms.

Heretofore the Exchange has required that the total liabilities of its members shall not be 20 times greater than their net capital. The present liquidity and safety of loans of their net capital made by brokers to their margin customers results from the relatively high margins which customers are required to deposit and maintain. Hence, a fairly high ratio of indebtedness to net capital may be carried with impunity. Nevertheless, the Exchange has agreed to require a reduction of the aggregate indebtedness of its members from the former maximum of 2000% to not more than 1500% of net capital.

If the requirement for a 15 to 1 ratio of debts to liquid assets is to be really useful, those assets comprising a broker's capital should include only items of readily realizable value upon which his customers may confidently depend. Because of the risks attendant upon the investment of brokers' capital in securities of fluctuating value, the Exchange has agreed that, for the purpose of determining the adequacy of capital, the market value of all securities other than United States Government issues which are carried for the account of the firm or its partners should be excluded from net capital. Also, as previously mentioned, all loans made by the firm to its affiliated dealer corporation are to be excluded from net capital. As a result, no such loan can be made under the proposed rules by the Exchange if it will impair the required 15 to 1 ratio.

On the other hand, aggregate indebtedness will include all customers' free credit balances except to the extent that they have been deposited in an earmarked account with an independent depository.

The text of the Exchange's proposed capital requirements is as follows:

> "The Committee on Member Firms rules that effective January 1, 1939, no member or member firm doing a general business with the public shall permit, in the ordinary course of business, his or its aggregate indebtedness as a broker to all other persons to exceed 1500 percentum of his or its working capital. For the purpose of this rule, aggregate indebtedness shall include money borrowed, except borrowings subordinated to the claims of general creditors of the member or firm, customers' unsegregated free credit balances, and all other obligations for the payment of money. For the purpose of this ruling, in computing the working capital of a member or firm there shall be excluded the valuation of memberships in Exchanges, furniture and fixtures, other fixed or slow assets, any indebtedness owing by its affiliated company, whether or not collateralized, unsecured receivables or deficits in accounts, the valuation of any securities or commodities, other than United States Government securities, carried for firm or partners' accounts, or for any customer's account (other than a "cash" account) which is in deficit, and purchase commitments for securities (other than United States Government securities), or commodities carried for such accounts."

As a practical matter this proposal will reduce the extent to which the safety of customers has been made dependent upon the shifting market prices of securities in which the firm may trade or speculate. It should also encourage the separation of a firm's dealer and underwriting activities in such a way that they may be conducted without risking the funds or securities of their brokerage customers.

RESTRICTIONS UPON WITHDRAWAL OF BROKERAGE CAPITAL

A further step of importance is the Exchange's proposal that the amount of a member's capital available for his commission business shall be stated to the Exchange and shall not be reduced except after formal notice to it. This proposal should tend towards stability of the brokerage capital which the firm has declared to be available. It should also deter excessive withdrawals of capital such as those which contributed to the failure of Richard Whitney & Company.

RESTRICTIONS UPON SPECULATION BY PARTNERS OF MEMBER FIRMS

The Exchange has not included in its program an additional safeguard which would be of real importance in reducing the danger of loss of brokerage capital through the speculation of partners. The disastrous effects of reckless security trading by partners is so clearly demonstrated by the facts of the Whitney failure as to need no further emphasis. Margin trading is probably the commonest source of partners' losses which not only jeopardize the safety of the firm but which create a major risk that customers' cash or securities may be embezzled in vain attempts to recoup losses. Although the Exchange does propose to limit margin trading by its member brokerage firms, it plans only to investigate the advisability of prohibiting margin trading by general partners. From the Commission's point of view any proposal which would restrain those entrusted with the conduct of a fiduciary business carrying the highest obligations to customers, from speculating on credit, would be highly desirable.

INCREASED SUPERVISION BY THE EXCHANGE OF THE CONDUCT OF THE BUSINESS OF MEMBERS THEREOF.

The shortcomings of the policies of the former management of the Exchange in respect of financial examination of its members are abundantly demonstrated by the fact that Richard Whitney & Company, insolvent since 1935, if not for longer, was able to act as a broker entrusted with the monies and securities of others until March of 1938. It is to the credit of the Exchange's questionnaire system that the first questionnaire which it required Whitney & Company to file revealed the clues which led to eventual exposure of the firm's insolvency and of Whitney's own thefts. With respect to its proposals to increase the frequency of filing financial statements by its members, to require independent audits of their business and to police its other requirements, the Exchange's program provides:

> " Financial Statements – The Committee on Member Firms will call for at least the following financial statements from all members who do a general business with the public, all member firms, and all companies affiliated with member firms:
>
> (a) A "long form" questionnaire (heretofore used only for member firms carrying margin accounts) at least once a year as a call for a detailed financial statement; and
>
> (b) a special "short form" questionnaire at each month-end between the calls for "long form" questionnaires.
>
> It is contemplated that calls made for the "long form" questionnaire will be issued at irregular intervals."
>
> " Independent Audits – The Exchange will require members or member firms doing a general business with the public and their affiliated companies to have an audit of their books, records and accounts made by independent public accountants at least once in each year. The scope of the audit is now the subject of a study being made by the Exchange and committees representing the American Institute of Accountants and the New York State Society of Certified Public Accountants."

> "   Exchange Auditing – Enlargement and expansion, by an augmented Exchange auditing staff, of supervisory audits, examinations and inspections of member firm and affiliated company offices and practices by Exchange auditors at irregular intervals and of a surprise nature. This inspection will include a test or spot-check of safekeeping securities and segregated securities representing excess margin."

> "   Enforcement – The business practices of member firms and of companies affiliated with member firms will be strictly supervised and the conduct rules will be rigidly enforced and where necessary severe penalties will be imposed for violations."

SPECIAL LOANS TO MEMBER FIRMS AND PARTNERS

Another source of danger illustrated by the Whitney case is the inadequacy of the present Exchange practice which does not require disclosure of special loans to brokerage firms and their partners. Part I of this report has pictured the frantic efforts of Richard Whitney to bolster the failing resources of his firm with borrowed funds.[1] Part I has also described the inability of persons loaning substantial sums to Whitney to learn of the similar loans by others or of the hopeless insolvency of his firm. The Exchange has therefore agreed to require by appropriate rules that all uncollateralized loans of more than $2500 made to members, or to partners of member firms shall be reported to the Exchange both by the borrower and by the lender. It will also require that all loans made to an affiliated dealer corporation shall be reported regardless of their size or the extent of their collateral security. The proposal reads:

> "   Member Borrowings – Every member, member firm, non-member partner of a member firm, and company affiliated with a member firm will be required to report forthwith to the Exchange all loans obtained, or indebtedness incurred in an amount of $2500 or more, by such member, member firm, non-member partner of a member firm, or company affiliated with a member firm, except such loans or indebtedness as are fully secured by readily marketable collateral. Every

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[1] It will be remembered that Whitney's borrowings on special loans amounted to a total of $6,172,800, obtained from 16 different members, member firms (or their partners.) Supra p. _____.

member, member firm, non-member partner of a member firm, or company affiliated with a member firm making any loan or advance to any other member, member firm, non-member partner of a member firm, or affiliated company shall likewise report the same to the Exchange, unless such loan or advance is fully secured by readily marketable collateral. All loans, secured or unsecured, regardless of amount, made by a member firm or any general partner thereof to any company affiliated with such firm, shall forthwith be reported to the Committee on Member Firms."

PROHIBITIONS AGAINST SPECIAL LOANS TO OR FROM OFFICERS OF THE EXCHANGE

Comparable to the non-disclosure of special loans is the practice, heretofore permitted, under which governors or other officials of the Exchange were free to make or receive loans to or from members whom, in their official capacity, they may later be called upon to judge. Richard Whitney borrowed substantial sums, often more than $100,000, from various member firms one or more of whose partners held positions of authority on the Exchange. The existence of such loans would obviously have placed those lenders in an equivocal position had they later been required to proceed against Whitney. In order to prevent its officials from acquiring any interest which might prejudice fair and uninfluenced performance of their duties to supervise and discipline the membership, the Exchange's program includes the following:

> " Prohibited Loans – No governor of the Exchange nor any officer or employee thereof shall make any loan to or obtain any loan from any member, member firm, non-member partner of a member firm or company affiliated with a member firm unless such loan be fully secured by readily marketable collateral."

Although the Exchange has not so required, it is recommended that it should call for reports of all fully collateralized loans from or to its officials and members even though under the proposed rule such loans are not prohibited.

REPORT OF UNDERWRITINGS

The Exchange has further agreed to obtain from its members weekly information as to their underwritings of securities either directly or through their affiliated dealer corporations and to obtain statements of net security positions resulting from underwritings. Because of the restraints which the Exchange's new capital requirements will impose upon the underwriting of securities by brokerage firms, it is anticipated that these reports will be principally obtained from the affiliated dealer corporations.

DIRECT DISCIPLINARY POWER OVER PARTNERS OF MEMBER FIRMS

On August 27, 1938 the Exchange submitted to its members for consideration a proposal for the creation of a new classification of "members", to be known as "allied members", which should include all non-member partners of member firms, their affiliated corporations, and all officers and directors thereof. This proposal if adopted would enable the Exchange to exert a direct supervision and control over all non-members managing the business of member firms and their affiliated corporations. As such it seems highly desirable.

SEGREGATION OF FREE CREDIT BALANCES

As previously noted the aggregate of customers' cash deposits in the form of free credit balances normally runs into hundreds of millions of dollars. These funds at the present time are commingled by brokers with their general funds and are employed as though they were a part of the firm's capital. Nevertheless, free credit balances represent a demand obligation against the brokers. Consequently, the Commission considers that customers' credits should be so treated as to assure the brokers' ability to repay them at all times. The Exchange has taken an intermediate step in this direction. Its proposals in respect of minimum capital requirements encourage but do not require the deposit of customers' free funds in a separate bank account by permitting the exclusion of credit balances from "aggregate indebtedness" if so earmarked. The Exchange's proposal is as follows:

> " Segregation of Free Credit Balances – Effective January 1, 1939, free credit balances segregated in one or more earmarked bank accounts approximating the total of their customers' free credit balances of thirty days' standing will not be considered a part of the aggregate indebtedness of member firms in the computation of required capital. Except to the extent that they have been so segregated, free credit balances will be considered an indebtedness."

In short, the program which the New York Stock Exchange has agreed to initiate will encourage its member firms to conduct their dealing, trading or underwriting operations through separate corporations and under such circumstances as will reduce the dangers to which their brokerage customers are now exposed. These proposals as previously noted, do not seek to prevent a person acting as a broker from having a direct interest in the business of a corporate dealer in securities. On the contrary, they are limited to strengthening the financial position of brokers and to separating the assets and liabilities of a member as a broker, from his assets and liabilities as a dealer. The latter is not mandatory. Divorcement of a dealer's risks from his brokerage business is encouraged only to the extent that the Exchange's capital requirements will give no credit for the market value of securities carried by brokerage houses for their own account. Whether this will be sufficient to bring about a real protection to customers from the risks which their brokers may undertake for their own account remains to be seen.

Although the program of the Exchange is, on the whole, eminently constructive, the Commission cannot disregard certain of its shortcomings. Of primary importance is the failure to require that members deposit customers' free credit balances in earmarked bank accounts.

Such accounts should be treated as trust accounts and should not be subjected to any liens in favor of the depository bank to secure its own loans to the broker. This freedom of earmarked bank accounts for customers' free credits from attachment at the hands of other creditors of the broker should be prerequisite to any dispensations under which free credit balances may be deducted from a broker's aggregate indebtedness. However, the Exchange proposes, for the purposes of its own capital requirements, to permit reduction of total liabilities to the extent that bank accounts equal to customers' funds are maintained without regard to whether the claims of bank or other creditors to such earmarked accounts are made subordinate to the rights of the customers. To affirmatively require the deposit of customers' free credit balances with an independent depository in an appropriately designated trust account would be a more effective measure. Again, the adequacy of the present proposal remains to be judged in the light of its operation.

The Exchange has also failed to prohibit margin trading by partners of member firms doing a brokerage business for the public. The Commission considers that elimination of margin trading by partners is equally as important as the elimination of margin trading by member firms. In fact, margin trading is probably the most common source of losses to partners -- losses which not only jeopardize the safety of the firm but also create strong temptations which occasionally have lead to the theft of customers' cash and securities.

Finally, and probably of most importance, is the failure of the Exchange to attack the problem of customers' fully paid or excess collateral securities as now kept under the control of its member brokers. The Commission deems it desirable that this property of customers should be removed from the control of brokers unless their financial position be so strong as to assure that there will be no temptation on the part of the broker to misuse his customers' fully paid securities. Among other methods to achieve this result is the suggestion that brokers retaining custody of customers' fully paid items be required to include their market value in figuring aggregate indebtedness. In the latter event their capital position under the proposed 15 to 1 ratio would have to be such as to minimize the risks of embezzlement or other forms of abuse.

These shortcomings of the Exchange's program for the better protection of its customers emphasize the need for a trust institution such as described above which will insure against the reckless or even illegal conduct of the brokerage business. Such an institution would provide a single solution to the numerous problems of solvency and customers' safeguards which are the subject of this report. It alone would mullify all of those dangers which the Exchange is now attempting to partially meet with a multiplicity of measures. Likewise, a trust institution would obviate the need for the further steps for the protection of customers which the Commission itself proposes to take. The potential evils inevitable in the present unsupervised combination of a brokerage business with a banking business and in the further combination of the assets and liabilities of a brokerage business with those of a dealer business might all be met and answered by a comprehensive trust institution to assume those custodial functions of the broker, the signal abuse of which, by Whitney & Company, necessitates this report.

ACTION WHICH THE COMMISSION PROPOSALS TO TAKE TO INCREASE THE PROTECTION OF CUSTOMERS AGAINST LOSSES ARISING FROM BROKERS' INSOLVENCY

Proposed Rules Under Section 8(b) of the Securities Exchange Act of 1934

The measures to be initiated by the New York Stock Exchange may well solve a major portion of the problems presented by the business of members of that Exchange. This Commission, however, faces a far broader problem than that confronting any one exchange. The protection of brokerage customers is a national problem which, although it can be best met by the joint action of this Commission and all of the national securities exchanges, now calls for rules of this Commission of nation-wide application. Consequently, there may be some duplication between the program of the Securities and Exchange Commission and that which the New York Stock Exchange proposes to put into effect -- an overlap which is inevitable if the Commission's rules are to deal realistically with these same dangers as they exist for customers of members of other exchanges and also of non-member brokers and dealers doing business through those members.

Under Section 8(b) of the Securities Exchange Act of 1934[1] the Commission is authorized to promulgate rules which will prevent the liabilities of brokers from exceeding their available net assets by an amount greater than may be found consistent with the public interest or the protection of investors. However, the statute provides that in no event can the Commission permit aggregate indebtedness to exceed 2,000 per cent of net capital. Hence, the Act authorizes the Commission, by its rules, to establish the maximum ratio of indebtedness to capital at any point below 20 to 1 which may be found necessary or desirable in order to protect investors.

Since the dissipation of the brokers' capital in the course of security trading or underwriting activities is the underlying cause of substantially all of the hazards now attendant upon the brokerage business, the Commission has determined to take the following steps to minimize those hazards.

In the first place, the Commission, under Section 8(b), will prohibit a member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any exchange member to permit, in the ordinary course of his business as a broker, his aggregate indebtedness to exceed net capital by more than 1500 per cent, or a ratio of 15 to 1 instead of the 20 to 1 ratio which is now the prevailing maximum.

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[1] Section 8 provides:
"<u>Restrictions on Borrowing by Members, Brokers, and Dealers</u>

"It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly --
"(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons, including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors."

As will be true of the New York Stock Exchange's requirements, the Commission's rules will define "aggregate indebtedness" to include all customers' free credit balances except to the extent that they are deposited in an ear-marked trust account with an exchange's central depository or some other independent depository. Furthermore, if appropriate measures for the control of their members are not taken by the various exchanges or if these measures prove ineffective in protecting customers, the Commission may find it necessary to proceed directly under its own powers as conferred by Section 19(b) to require the deposit of safekeeping items in an earmarked trust account with a central depository or other independent custodian.

"Net capital", on the other hand, will be defined by the proposed rules under Section 8(b) so as to include only such borrowed funds as are subordinated to the claims of customers and general creditors. Excluded from capital will be all advances or loans to employees and partners or to the broker's affiliated underwriting or trading corporation, if any. The proposed rules of the Commission will also exclude from "net capital" unsecured loans and some percentage of the market value of all securities.

The Commission proposes to supplement its capital requirements under Section 8(b) by further action to be taken pursuant to Section 19(b). Under the latter provision of the statute the Commission may recommend that the exchanges, in order adequately to safeguard the financial responsibility of their members, should adopt rules permitting their members to purchase securities of speculative or fluctuating value only with such funds as may not be necessary to maintain the 15 to 1 ratio of capital to indebtedness to be imposed by the rules under Section 8(b).

Rules Under Section 8(c) of the Securities Exchange Act of 1934.

The danger of misuse of customers' securities has been reemphasized by the Whitney case. It is therefore essential that the broker's powers to repledge his customers' margin securities be so limited as to minimize the possibility of their embezzlement or excessive rehypothecation.

Section 8(c) of the Securities Exchange Act of 1934[1] provides for rules and regulations to prevent brokers from repledging their customers' securities except to the extent necessary to finance those customers' margin accounts. These rules, as contemplated by the Congress, must so operate that "a broker cannot risk the securities of his customers to finance his own speculative operations". The Commission, therefore, proposes not only to prohibit the commingling of customers' securities without written consent, but also to prohibit the commingling of customers' securities, regardless of consent, with the securities of any person other than a customer. Equally important will be the rule prohibiting a broker from repledging customers' securities for an amount greater than the aggregate indebtedness of all of the customers in respect of the securities thus repledged.

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[1] "Sec. 8. It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly --
"(c) In contravention of such rules and regulations as the Commission shall prescribe for the protection of investors to hypothecate or arrange for the hypothecation of any securities carried for the account of any customer under circumstances (1) that will permit the commingling of his securities without his written consent with the securities of any other customer, (2) that will permit such securities to be commingled with the securities of any person other than a bona fide customer, or (3) that will permit such securities to be hypothecated, or subjected to any lien or claim of the pledgee, for a sum in excess of the aggregate indebtedness of such customers in respect of such securities."

Rules Under Section 17 of the Securities Exchange Act of 1934.

This provision of the Act relates to the keeping of books and records by members of national securities exchanges and registered brokers or dealers. The Commission proposes in the immediate future to promulgate rules requiring the keeping and preservation of books and records essential to the safe conduct of a brokerage business.

The Program of Future Commission Action Which May Become Appropriate in Relation To The Measures Outlined Above and Suggested for Adoption by National Securities Exchanges and National Securities Associations.

The Commission is of course fully cognizant that a program for the protection of customers against losses resulting from brokers' insolvency would be most effective if initiated by the various exchanges. The Commission further recognizes that only by cooperation and joint action can the series of safeguards proposed in this report be put into operation with a minimum of burden to the Exchanges and their membership, and with a maximum of protection to their customers. The Commission, therefore, recommends that the other national securities exchanges, as well as those contemplating the formation of national securities associations under the recently enacted Section 15A of the Act, consider and appraise these proposals in the light of the situations peculiar to each. Certain of the measures which the New York Stock Exchange has proposed may not be applicable to members of all of the other securities exchanges or to all brokers and dealers. Nevertheless, the principles which underlie these proposals rest upon sound business ethics and good conscience. This Commission stands ready to lend its fullest powers to any exchange or association which desires to adapt these proposals to their own situations. Finally, since the proposed rules of the Commission concern matters within the field of an exchange's powers of internal regulation, the Commission may find, to the extent that the various exchanges or national securities associations may adopt these or similar safeguards for customers, that it can relax or remove altogether some of its own regulatory provisions which may thus be rendered unnecessary.

On the other hand, should an exchange fail to fulfill its public responsibilities, this Commission may be compelled to institute formal proceedings pursuant to Section 19(b) of the Securities Exchange Act of 1934. This Section provides for the required adoption by national securities exchanges of rules including those for "safeguards in respect of the financial responsibility of members". These proceedings, if instituted, would determine the necessity and appropriateness in the public interest of requiring each exchange to adopt such measures for the protection of customers as may best fit the type of business conducted by its members and the economic circumstances under which it operates. The Commission is also prepared, if necessary, to determine whether members of exchanges, while acting as brokers, should be permitted to perform banking functions unless subjected to supervision comparable to that which now safeguards the banks, trust companies and other financial institutions of this nation.

CONCLUSION

The necessity of translating the foregoing suggestions into a concrete program rigorously supervised and enforced arises from the fact that national securities exchanges are public markets impressed with the public interest and essential to the economy of the United States. To establish safeguards that will assure the investor protection from those who would use his money and securities entirely for their own purposes or who would subject his funds and property to unconscionable risks is the aim of this Commission. Ultimately such a result is partially dependent upon the attitude of mind of the brokers and dealers themselves. As long as a securities exchange is regarded as a private club membership in which is considered a special privilege for private gain heedless of responsibilities to the public, the objectives cannot be attained. A member's obligations to investors must outweigh those which he feels toward his fellow members and his conduct must reflect such an attitude. This cannot be accomplished by regulation alone for it involves matters of the spirit, beyond legislative reach. The Whitney inquiry has revealed the great degree to which this objective is as yet unattained. In great number Richard Whitney's associates on the Exchange gave evidence of their unwillingness or inability to recognize their responsibility to notify the Exchange of the facts indicating or establishing his misconduct and insolvency. The interests of the public were subordinated to self-interest. So grave is the situation disclosed that a re-definition of a member's obligations seems just as necessary as a vigorous maintenance of the standards of business outlined in this report. Those appointed by the membership of a national securities exchange and charged with the duty of enforcing the rules of that exchange must hold themselves above suspicion and so conduct their own businesses as to assure the conscientious exercise of their responsibilities. The picture which is presented by a responsible officer of the Exchange being called upon to discipline a member to whom he is privately indebted in a substantial amount, the repayment of which might seriously undermine the financial condition of his firm, is not one to inspire public confidence. Nor is it conducive to effective self-regulation.

And the spectacle of a member who refuses and denies any responsibility to report another member's illegal acts is far from reassuring to those in Government or elsewhere who have looked to the exchanges for demonstration of their ability to function in the interests of those whom they ultimately serve. It is obvious that the members who testified that they considered it entirely proper not to advise the Exchange of Whitney's illegal conduct or insolvency and to allow him, despite his embezzlements, to remain a member not only of the Exchange but also of the Board of Governors, reveal the attitude that the Exchange was not a public institution owing grave responsibilities to the thousands of investors served by it. That attitude--the attitude that the Exchange was essentially a private club so that illegal acts of its officers were not in any manner like the illegal acts of a bank officer--had a long history. It was a well entrenched customary attitude. There is, therefore, perhaps no basis for moral censure. Hence, we do not indulge in moral recriminations. But we can properly condemn, and we do, the traditions which may explain that conduct, and insist that henceforth members of exchanges as well as brokers and dealers in the over-the-counter market must recognize their public responsibility or ultimately forfeit their privileges to those who will.