order for public proceedings dated June 8, 1962, charged that advertising contained untrue statements of material facts or were otherwise false or misleading with respect to "the performance of past recommendations," "the prospects for price increases of securities recommended," and the "number and qualifications of the staff" of the adviser. It also charged that statements were made which the registrant "knew, or in the exercise of reasonable care could have discovered, were false or misleading" regarding purported Government contracts of a company recommended by the publication.

While an appropriate self-regulatory organization may ultimately be the most desirable agency for improving practices in the investment advisers' field, in view of the present absence of such an organization it would seem desirable for the Commission further to exercise its regulatory powers in respect of problem areas other than advertising. While the broad antifraud provisions of the act clearly cover fraudulent activities, however novel, there are areas where more definitive rules might prove helpful, for example, in regard to the failure of the advisory material itself to disclose research techniques used and/or the preparation of research materials by personnel outside the firm, which may well be deceptive to subscribers.

9. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Recent years have seen a vast increase in the amount of published material directed by the financial community to the investing public and devoted to describing, advising, recommending and in some cases urging the purchase of particular securities. The greater part of this material is prepared by broker-dealer firms and sent without charge to their customers and to potential customers whose names may come from mailing lists or responses to advertisements. A smaller but still significant portion is prepared by firms not engaged in selling securities but registered with the Commission as investment advisers who, for a subscription fee, provide information and recommendations on specific securities through periodical publications, sometimes supplementing the recommendations in the periodical with some personal investment advice to the subscriber.

Published advisory materials have been produced by both sources in large and increasing volume. As might be expected, they have had an influence on investors and the security markets. When responsibly prepared, these materials play a useful part in the flow of reliable information about securities which is so important to sound investment decisions. When irresponsibly or recklessly prepared, or when too casually based on unfounded statements of unreliable company managements, they can start a chain reaction which may end in disaster for many investors. Such a chain reaction and its effect on the public was illustrated in the eager recommendations of the stock of Dunn Engineering Co. by publications of broker-dealers and subscription publishers alike shortly before the company's bankruptcy.

The preparation and dissemination of printed advisory matter has become an ordinary part of conducting a successful retail securities business today and plays an important part in sales promotion. The most common forms taken by broker-dealer published material are the market letter, sent daily or weekly, the research report, devoted to recommending a specific company or group of companies and sent regularly or occasionally, a monthly report and special securities reports, often in finished magazine form. Some of this material contains detailed and extensive exaluations of the merits, risks, and prospects of the securities considered. Far more of it does not purport to make any detailed analysis to support the recommendations. It generally classifies the securities in terms of investment goals, but omits any consideration of adverse data or uncertainties. Overwhelmingly the recommendations are to purchase; recommendations to sell securities are few, and for the most part deliberately avoided, even with respect to securities previously recommended whose prospects may have changed. The core of the recommendation is generally a projection, which often is in the form of an estimate of future earnings but which sometimes involves an outright prediction of a future market price well in excess of the present market. Ordinarily little information is given concerning the extent or method of research and about the person responsible for the recommendation. Moreover, usually there is no indication of any interest in or intentions as to the securities recommended on the part of the distributing broker-dealer firm, since few disclosures of these facts go further than an unrevealing boilerplate hedge clause.

While the material produced by subscription publishers is not principally designed as sales promotion material, and reflects on its face a greater diversity in research approaches than the material of broker-dealers, it is nevertheless similar in many respects. As in broker-dealer material, recommendations to buy securities are overwhelmingly predominant, although recommendations to sell are not as scarce. Also, like broker-dealer material subscription publications are almost uniformly silent on the subject of their publishers' positions and intentions with respect to recommended stocks.

Common to printed material of broker-dealers and subscription publishers alike is the suggestion, express or implied, that their recommendations are the product of research. The study's survey of the research practices followed by firms in each category revealed wide variations in the practices followed and the adequacy of research staffs to perform the functions they were called on to perform, as well as a frequently broad gap between the practices followed and the standards professed. At the upper end of the scale, firms in each group followed practices which were meticulous, painstaking, and time consuming. At the other extreme were investment adviser firms with limited staffs and what can at best be described as a casual approach to research, and broker-dealer firms with obviously overburdened research departments. In the research departments of broker-dealer firms, which publish regular market letters and other selling material, answer a steady stream of questions from salesmen and their customers, review portfolios for customers and potential customers, and often prepare special reports for institutional customers, the study also found wide variations in the standards applicable to differing research functions. As a general policy, the highest quality research efforts are directed to institutions and substantial customers, and the most casual efforts are generally directed to review of portfolios submitted in response to newspaper advertisements.

Reliance on outside sources for research services also occurs in both broker-dealer and investment adviser firms. Some firms circulated material prepared by the research departments of larger correspondent firms or independent research organizations, with or without disclosure of the source. On the other hand, the occasional circulation by broker-dealers under their own names of material prepared by public relations counsel of the company whose stock is recommended, or by advertising firms or others, represents an abdication of responsibility.

Both broker-dealers and investment advisers almost inevitably find themselves on some occasions in situations where the nature of the advice they give to the public may be affected by consideration of their own interests. The most common situations involve the broker-dealer's failure to disclose its position or its marketmaking activities in a stock it recommends. Whatever the motives, which may be good or bad, the legal and ethical responsibilities in such situations are not clearly defined. A wide variety of views exists even on the propriety of using market letters to recommend a security in which the firm has a position which it has decided to liquidate. Diversity of opinion similarly exists concerning the propriety of making recommendations available in advance of publication to certain favored classes of customers. The study found evidence of some practices, however, which go to the basic question of good faith: in both broker-dealer and investment adviser firms the study found cases of proprietors and employees "scalping," or buying securities which they were about to recommend, in anticipation of the market impact of the recommendation, and selling immediately thereafter.

The investing public gets only modest protection from existing Government and industry controls over the form and content of investment advice and the manner in which it is produced and disseminated. Printed investment advice of broker-dealers, which is essentially sales-promotion material, is subject to Federal control through the application of the Federal antifraud statutes, and both the NYSE and the NASD have promulgated broad general standards applicable to it. However, the Commission has concentrated its efforts on the selling literature of boiler-room-type broker-dealers, and makes no concerted effort generally to police the mass of sales-promotion material of all broker-dealers subject to its jurisdiction. While the NYSE has established "guideposts" for the preparation of sales material, a number of firms appear to pay little attention to them, and although the exchange has recently devoted more effort to a program of reviewing this material, its activities still fall considerably short of vigorous self-regulation. Similarly the general standards articulated by the NASD suffer from largely ineffective enforcement.

The self-regulatory agencies have been slow to accept their responsibilities in this area. Only at the urging of the Commission did the exchanges and the NASD establish even the modest controls now afforded by their programs for review of selling literature. The New York Stock Exchange still encourages its members to advertise their research and advisory activities without concerning itself with their ability to perform the services which they purport to perform. The exchange's inquiries into trading against market letters came only after the disclosure of such activity by the study. In areas of other ethical questions—disclosure in advisory material, other than by meaningless hedge clauses, of positions, trading intentions, and marketmaking activities; preferential treatment of different categories of clients; responsibility for following recommendations—the self-regulatory agencies have not provided leadership.

Unfortunately, the registered investment advisers operate largely in an area which lacks any guiding self-regulatory organization. The emergence of such an organization, which could formulate standards and educate its industry to a higher ethical plane, is highly desirable. Absent such an organization, it will remain for the Government to take further steps for the protection of investors in respect of the problems which have come to light.

The responsible dissemination of sound investment advice, even as a method of sales promotion, is clearly beneficial to the investment community at large. It can be assisted by governmental measures which may clarify some cloudy areas of legal responsibility, and encourage the dissemination of reliable information, officially and unofficially, by issuers. Irresponsible dissemination of advice, however, has been responsible for injury to the public investor and to the reputation of the entire investment community. It behooves the responsible leaders of that community, and particularly its self-regulatory institutions, both to clarify the ethical responsibilities of its members and to promote the establishment of reasonable standards which the disseminators of investment advice may be expected to meet.

The Special Study concludes and recommends:

1. Investment advice furnished by broker-dealers, though an integral part of their business of merchandising securities, is incidental to that business and, for the small investor particularly, their facilities for providing advice are quite varied in quantity and quality. This being the case, a minimum protection for such investors is that firms should not be permitted to represent that they perform research or advisory services which they are not reasonably equipped to perform. The New York Stock Exchange, instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard, and the NASD should provide similarly for its membership.

2. Specific practices with respect to investment advice, whether expressed in market letters, advertisements or otherwise, should receive more positive and effective attention from the self-regulatory agencies. Such agencies obviously cannot assume responsibility for the staffing of their member firms or the quality or validity of specific recommendations, but they should assume responsibility for eliminating irresponsible or deceptive practices by their member firms. This area also lends itself to establishment of standards through statements of policy, covering such matters as (a) required disclosures in printed material of sources of information, research techniques used, and/or other bases of recommendation, rather than general disclaimers as to sources and reliability of data in market letters; (b) required disclosures in written advice of existing positions, intended dispositions, and market-making activities, rather than general "hedge" clauses as to possible present conflicting positions or transactions; (c) required indication of the name of the person responsible for the

preparation of market letters, and dating of such material; (d) in printed investment advice which purports to analyze issuers, required references to most recently filed official disclosures by issuers, and representations that such filed information has been examined, with specific identification of issuers for which no officially filed information is available; (e) prohibition of specific practices in connection with written or oral recommendations, such as predicting specific future price levels of particular securities, claiming "inside" information by reason of a directorship, and trading against recommendations or other self-dealing; and (f) required disclaimers in connection with salesmen's written or oral recommendations not emanating from a firm's research department or otherwise sponsored by the firm.

3. The market letter surveillance program of the New York Stock Exchange should be strengthened and redirected toward achieving greater responsibility and restraint in the use and contents of such letters. More effective market letter surveillance should also be undertaken by the NASD and the other exchanges, or a coordinated program of self-regulatory agencies should be evolved.

4. Reckless dissemination of written investment advice by broker-dealers, whether or not for a separate fee, or by registered investment advisers, should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability in favor of customers reasonably relying thereon to their detriment. Without limiting the general principle, written investment advice which purports to analyze issuers but fails to consider most recently filed official disclosures of issuers should be one of the factors to be considered in determining whether such advice is recklessly disseminated.

5. As recommended in chapter II, registered investment advisers other than broker-dealers, should be organized into an official self-regulatory association or associations, which should then adopt and enforce substantive rules corresponding to those recommended above in respect of advisory activities by broker-dealers. Alternatively, the Commission should extend and strengthen its own direct regulation of advisers to accomplish the purposes indicated.

D. Protection of Customers' Funds and Securities

1. CONDUCT OF CUSTOMERS' ACCOUNTS

a. Purpose of study

The purpose of this part is to continue the study of the broker-dealer financial responsibility rules begun in chapter II.B. There, bonding and minimum capital rules that have an impact at the point of entry into the business were examined; here certain rules governing the conduct of broker-dealer business operations are reviewed. The rules discussed relate to custody and use of customers' assets, and to net capital ratios. It is appropriate to consider whether they provide adequate protection to investors by reducing the probability of broker-dealer insolvency and by correlating adequately with the provisions of Federal bankruptcy law in the event that such an insolvency occurs.

The rules treated include those embodied in certain State and Federal statutes and those of the Commission, national securities exchanges, and the NASD. Their adequacy, in substance and enforcement, is fundamental to the health of the securities business because the broker-dealer community regularly has custody of and uses customers' funds and securities of enormous value. Substantial unprotected losses to the public resulting from misuse of customers' assets or other practices which the rules are intended to protect against, would cause, in addition to injury to the public, serious harm to the industry's reputation.

b. Method of study

The study of financial responsibility rules was carried out through interviews with officials of certain exchanges, the NASD, partners and officers of various types of broker-dealers, stock brokerage accountants, and certain other informed persons; through review of currently applicable laws and rules and regulations; and through analysis of answers to questionnaire FR-1,[314] distributed to 245 selected broker-dealers throughout the country. The questionnaire requested information with respect to transmission of statements to customers; practices relating to custody and use of, as well as protection for, customers' cash balances and customers' securities; hypothecation and lending of customers' securities; handling of margin accounts and nonpurpose loans (see ch. X); and bonding (see ch. II.B). Distribution of the questionnaire was limited to 245 broker-dealers conducting a general retail securities business with the public, since it was believed that specialized operations, e.g., mutual fund retailing and nonpublic business, would not present certain of the problems on which interest centered. Usable responses were obtained from 228,[315] including 50 members of the NYSE, 15 regular or associate members of the Amex, 44 regional-only exchange members, and 119 broker-dealers not exchange members. The responses are believed to present a representative sampling of the practices and procedures of the full spectrum of general retail broker-dealers.

c. Types of accounts

As a preliminary to consideration of the financial responsibility rules, the nature of the principal relationships that normally exist between broker-dealers and their customers should be briefly delineated. The technical characteristics of various types of accounts are discussed in chapter X; here only general attributes are noted.

The principal types of brokerage accounts are "cash" and "margin" accounts, technically designated as, respectively, "special cash" and "general" accounts. Numerous other types of accounts are also prescribed under the applicable regulations and the rules of the various exchanges. Cash and margin accounts, however, are the basis for such

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[314] See app. III-J.

[315] 17 of the original 245 broker-dealers in the sample were not included for the following reasons:

(a) 12 did not reply (at least 4 of these are no longer in business and 2 are insolvent);
(b) 2 were merged with other firms and no longer operate independently;
(c) 2 had no public business;
(d) The principal of one firm is recently deceased and the firm is winding up its business.

a vast proportion of all tranactions affected by members of the public that only they need be discussed in relation to the financial responsibility rules.

The cash account is operated on the assumption that the customer will promptly pay for securities purchased and that securities sold are in his possession and will be promptly transmitted to the broker-dealer for delivery to the purchaser. As its name indicates, the essential characteristic of a cash account is that the broker does not extend credit for customer transactions.

In the margin account, the broker-dealer does extend credit to the customer to purchase securities.[316] A "margin" transaction creates in the customer's account a debit balance in the amount of the loan, on which the customer pays interest. Another form of margin transaction occurs when a customer effects a "short" sale, i.e., sells a security he does not own, or owns but does not wish to deliver, and makes delivery by borrowing the security. Thus in one form of margin transaction money is borrowed, whereas in the other it is securities.

Market studies of the NYSE indicate that, among members of the public, a greater proportion of shares are purchased and sold in cash accounts than in margin accounts. Since September 1952, the NYSE has conducted 12 transaction studies, each covering a 1- or 2-day period except the last, which covered May 28, 29, and 31, 1962.

Considering the share volume only of public individuals for three of these periods, the results are as follows:

TABLE III–a.—*Share volume of public individuals on the New York Stock Exchange*

Period	Cash transactions	Margin transactions
	Percent	*Percent*
May 1962	64.6	35.4
December 1954 (estimated)	56.7	43.3
September 1952 (estimated)	75.8	24.2

Considering the total share volume for these periods, the results are:

TABLE III–b.—*Public transactions as percent of total share volume on the New York Stock Exchange*

	Public's cash transactions	Public's margin transactions
May 1962	36.7	20.1
December 1954 (estimated)	35.3	27.0
September 1952 (estimated)	43.2	13.8

Source: NYSE, "The Stock Market Under Stress: The Events of May 28, 29, and 31, 1962," pp. 14, 17 (1963).

The average figure for margin transactions of public individuals for the 12 studies is 20 percent. The significance of these figures becomes

[316] The extension of credit by broker-dealers is governed by regulation T of the Federal Reserve Board. For a more detailed discussion of regulation T, and of regulation U, governing extension of credit by banks on securities to members of the public for the purchase of securities, see ch. X.

apparent when it is realized that, as shown by the study's questionnaire OTC-3,[317] the NYSE accounts for a large proportion of all margin transactions.[318]

d. The nature of agreements between broker-dealers and their customers

Few firms, apparently, use written agreements to establish conditions for the conduct of cash accounts.[319] Even among those few, the terms of the agreements [320] vary widely.

All of the 79 FR-1 firms that carry margin accounts require the execution of "margin agreements." Further, the agreements themselves are much more uniform in content and language than the cash account agreements. There is good reason for this. A margin account, by its very nature, demands that the broker-dealer have considerable dominion and control over assets in the account. Securities in the account stand at all times as collateral for the customer's indebtedness and may have to be rehypothecated by the broker-dealer. Thus they must be treated much as though they were the broker-dealer's own property. Without an agreement defining the broker-dealer's rights, the extent of these rights may be uncertain or unduly limited. In certain jurisdictions, for example, he may not rehypothecate any securities for a greater amount than the customer owes, without specific written consent.[321] The vagaries of local law need not be explored here; suffice it to say that they have resulted in a form of margin agreement which is substantially uniform throughout the securities industry. The Association of Stock Exchange Firms has developed a standard form, ASEF 101 (see app. III-C), which is used by 25 of the 49 NYSE firms that carry margin accounts and responded to FR-1. The remaining 24 NYSE and 30 Amex or regional exchange firms use modifications of that form or other forms with substantially identical provisions.

Typically, margin agreements give the broker-dealer the following rights with respect to his customers' assets:

1. All property, including money, securities or commodities which the broker-dealer may be holding for a customer, whether for safe-

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[317] See ch. VII.

[318] See ch. X.

[319] The following tabulation shows the use of written cash-account agreement by the respondents to FR-1:

Exchange affiliation of firms	Total number in sample	Number having cash account agreement	Percent of total number
NYSE	50	16	32.0
Amex	15	4	26.7
Regional exchanges	44	5	11.4
No exchange membership	119	12	10.1

[320] One prominent member firm of the NYSE, for example, requires only that an information card be signed in which the customer warrants that he is more than 21 years of age. By contrast, a smaller NYSE member firm uses an agreement containing rather elaborate terms. The form of the latter agreement is shown in app. III-A.

With respect to both cash and margin accounts, many broker-dealers attempt to establish the conditions under which transactions take place by statements on the back of confirmations. See, for example, app. III-B. Many factors obviously enter into a conclusion as to whether these statements actually are a part of the contract between a customer and a broker-dealer, but it is clear that they are not in all cases.

[321] See, for example, New York Penal Law, sec. 956. For a general discussion see Meyer, "The Law of Stock-Broker and Stock Exchanges" (New York, 1931) (supplement, 1936), sec. 69 et seq.

keeping, transmission or any other purpose, is subject to a lien for the discharge of all obligations of the customer to the broker.

2. All such property held by the broker-dealer may be pledged, repledged, hypothecated, or rehypothecated without notice to the customer for the amount the customer owes the broker-dealer or for a greater or lesser amount. The broker-dealer need not retain in his possession a like amount of any securities or other property deposited.

3. If the customer should die or become incompetent or if the broker-dealer should deem it necessary for his own protection, the broker-dealer is authorized to sell any or all securities, commodities, or other property which is in his possession and which is held for the account of the customer without notice to the customer, and without restriction as to market or conditions of sale.

4. The broker-dealer is authorized to borrow for a customer any securities which may be necessary in order to effect sales ordered by that customer if he is unable to make delivery.

Additionally, the customer is required to sign a separate loan consent that typically reads as follows:

> Until you receive written notice of revocation signed by the undersigned, you are hereby authorized to lend, to yourselves as brokers or to others, any securities sold by you on margin for the account of, or under the control of the undersigned.

The terms of the usual margin agreement are entirely for the benefit of the broker-dealer, except that the agreement typically states that all transactions thereunder are subject to the constitution, rules, regulations, customs and usages of the exchange or market where the transaction is executed and also subject to the provisions of various State and Federal regulatory laws, rules, and regulations. This one sidedness is not necessarily improper. It is obviously vital that the broker-dealer who lends money to his customers have a wide measure of freedom of action in order to protect himself in the event of a break in the market or in the value of securities in a particular account. Inflexibility, indeed, might lead to impairing the broker-dealer's solvency and jeopardizing his other customers' funds. The one-sided nature of these agreements indicates, however, the importance of the rules and regulations of various State and Federal regulatory agencies as well as those of the exchanges and the NASD in providing rights and protection for customers.

e. Notice to customers as to status of accounts

Broker-dealers report to customers in two ways. They are required by section 11(d)(2) of the Exchange Act and the Commission's rule 15c1-4 [322] to supply confirmations in which essential information is

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[322] Sec. 11(d)(2) reads as follows:

"It shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member * * *. (2) Any transaction with respect to any security (other than an exempted security) unless, if the transaction is with a customer, he discloses to such customer in writing at or before the completion of the transaction whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person."

Rule 15c1-4 reads as follows:

"The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker or dealer designed to effect with or for the account of a customer any transaction in, or to induce given about each purchase and sale in the customer's account. A confirmation, however, does not reveal the status of a customer's account. In addition, broker-dealers render periodic statements of account, although no rules of the States, the Commission, the exchanges or the NASD require such statements and it would appear that practices vary widely with the type and methods of business. Interviews conducted by the special study indicate that firms equipped with computers ordinarily send statements to customers having open accounts at the end of each accounting period, usually monthly. Other firms, particularly those doing solely a cash business, send statements to customers less often, perhaps quarterly or only on request.

This disparity of practice is reflected in the answers to FR–1. The answers of all firms in the sample were tabulated in order to determine the frequency with which statements were sent to customers having cash accounts. These results are shown below.

TABLE III–c.—*Statements sent by firms in FR–1 sample to customers having open cash accounts (irrespective of activity in accounts)*

Exchange membership	All sample firms		Firms sending statements					
			Monthly		Quarterly		Other	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
NYSE	50	100.0	22	44.0	20	40.0	8	16.0
Amex	15	100.0	3	20.0	2	13.3	10	66.7
Regional exchanges	44	100.0	10	22.7	4	9.1	30	68.2
Nonexchange member	119	100.0	6	5.1	8	6.7	105	88.2
Total	228	100.0	41	18.0	34	14.9	153	67.1

The practices of the 79 broker-dealers in the sample carrying margin accounts also were analyzed. It was found that even among these firms (excepting members of the NYSE), customers having margin accounts were more likely than customers having open cash accounts to receive monthly or quarterly statements. These results are tabulated below.

the purchase or sale by such customer of, any security (other than United States Tax Savings Notes, United States Defense Savings Stamps, or United States Defense Savings Bonds, Series E, F, and G) unless such broker or dealer, at or before the completion of each such transaction, gives or sends to such customer written notification disclosing (1) whether he is acting as a broker for such customer, as a dealer for his own account, as a broker for some other person, or as a broker for both such customer and some other person; and (2) in any case in which he is acting as a broker for such customer or for both such customer and some other person, either the name of the person from whom the security was purchased or to whom it was sold for such customer and the date and time when such transaction took place or the fact that such information will be furnished upon the request of such customer, and the source and amount of any commission or other remuneration received or to be received by him in connection with the transaction."

TABLE III-d.—*Statements sent by firms in FR-1 sample that carry margin accounts (irrespective of activity in accounts)*

Exchange membership	All sample firms		Firms sending statements					
			Monthly		Quarterly		Other	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
	To customers having margin accounts							
NYSE	49	100.0	30	61.2	13	26.5	6	12.3
Amex	9	100.0	4	44.5	2	22.2	3	33.3
Regional exchanges	14	100.0	10	71.4	2	14.3	2	14.3
Nonexchange members	7	100.0	3	42.8	2	28.6	2	28.6
Total	79	100.0	47	59.5	19	24.0	13	16.5
	To customers having open cash accounts							
NYSE	49	100.0	21	42.8	20	40.8	8	16.4
Amex	9	100.0	2	22.2	2	22.2	5	55.6
Regional exchanges	14	100.0	4	28.6	3	21.4	7	50.0
Nonexchange member	7	100.0	1	14.2	1	14.2	5	71.6
Total	79	100.0	28	35.5	26	32.9	25	31.6

On the basis of the FR-1 sample it would appear fair to say that the customer-statement practices of broker-dealers show some lack of businesslike procedure. A margin customer or a customer whose securities are in the hands of a broker-dealer for safekeeping should be entitled to at least a quarterly rendering of account. The present practices, moreover, assume even greater significance in relation to customers' free credit balances, discussed below.

2. CUSTOMERS' ASSETS IN POSSESSION OF BROKER-DEALERS

Generally speaking, the customers' assets of which broker-dealers have custody fall into four categories: customers' "free credit" balances; customers' cash balances other than free credit balances; customers' "fully paid" securities; and customers' securities in margin accounts.[323] The financial responsibility rules should be considered in light of the means by which broker-dealers acquire and hold these assets and the purposes for which they are used.

a. Free credit balances

Free credit balances are those amounts of cash owed by broker-dealers to customers which the customers have an immediate, unrestricted right to withdraw. The NYSE explains the term as follows: "The cash credit balance available in customers' accounts for use by the customers. A credit balance caused by a short sale is not a free credit balance." [324]

Free credit balances come into being in the normal course of the broker-dealers' business. The balances are created, typically, when a

[323] No attempt is made in this report to discuss problems arising in connection with commodities accounts or nonpurpose loan accounts. With respect to the latter, see ch. X.
[324] New York Stock Exchange Fact Book (1962), p. 26.

customer gives cash to a broker-dealer with the advice that instructions for the purchase of securities will follow; or a customer instructs a broker-dealer to sell securities and the broker-dealer, either on its own initiative or upon the direction of the customer, holds the proceeds pending reinvestment or other instructions; or, a broker-dealer receives and does not immediately transmit interest and dividends on customers' securities he holds in "street" name.[325]

Although precise figures as to the balances held by all broker-dealers in the country are unavailable, some idea of their magnitude may be gained from the available figures with respect to NYSE member firms which numbered 681 on January 1, 1962. Month-end free credit balances reported by these firms varied between totals of $1,207 million and $1,508 million during 1961.[326] It is possible that the member firms of the NYSE account for a large proportion of free credit balances held by all registered broker-dealers in the country, but holding of free credit balances is by no means restricted to such firms. The Washington regional office of the Commission conducted a study of 66 of the 141 registered broker-dealers in Washington, D.C., as of March 31, 1962. Eleven were member firms of one or more registered national securities exchanges and 55 were not. The 11 exchange member houses held free credit balances of $6,619,000, while the 55 nonmember houses held free credit balances of $281,000.

The likelihood that a firm will come into possession of and hold free credit balances of its customers depends on its type of business. A retailer of mutual funds, for example, will be most unlikely to come into possession of substantial customers' funds. The difference between such a firm and the large wire house is dramatically illustrated by comparing the annual financial reports to the Commission of the 10 largest wire houses in the country with 10 largest mutual-fund retailers.[327] The former reported aggregate free credit balances of $428,496,529, while the latter held only $175,581.[328]

Similarly, a small broker-dealer who buys and sells securities for customers in limited amounts and in conjunction with another business he is conducting is less likely to hold extensive free credit balances. Naturally this is not invariably true and instances can be found in which small broker-dealers hold amounts of free credit balances that are large in relation to their net capital. It is among the large broker-dealers, however, such as the wire houses, that free credit balances are held in enormous volumes. Merrill Lynch, Pierce, Fenner & Smith, Inc., for example, in its annual report to the Commission for 1961 stated that on May 26, 1961, it held approximately $233 million in free credit balances. This is by far the largest firm in the country, but other firms hold free credit balances in amounts running into millions of dollars.

From the point of view of the broker-dealer, free credit balances represent a desirable source of funds since generally they can be used

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[325] See app. III-D.
[326] See NYSE Fact Book, p. 27.
[327] Both categories are measured by number of salesmen.
[328] The figures are aggregated here although the financial reports to the Commission, from which they were compiled, were not all filed at the same time. The figures used were the latest available as of Dec. 31, 1961.

interest-free.[329] The industry has taken the position that it is severely restricted in paying interest by section 21 of the Banking Act of 1933, which prohibits a broker-dealer from engaging in "* * * the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor * * *." [330] An opinion of counsel published in 1934 by the Association of Stock Exchange Firms, entitled "Memorandum Regarding Section 21 of the Banking Act of 1933," discussed various practices in the securities business which might be deemed to be indexes of "receiving" deposits. With respect to payment of interest on credit balances, it stated:

> * * * It is recommended that interest should not be allowed on any customer's credit balance in excess of the current comparable commercial bank rate, if any. The payment of excess interest on such balances should not of itself affect the character of such balances so as to make them "deposits" within the meaning of the act. Nevertheless it is believed wise to avoid this practice which would inevitably result in the encouragement of customers to keep funds with private firms rather than with banks with the likelihood that the account might be gradually transformed from a bona fide investment account to a deposit account.[331]

The NYSE, whose members hold immense amounts of free credit balances, has informally promulgated the view that interest can be paid on free credit balances only at a half point or more below the going call-money rate. Any higher rate, it is felt, would be "encouraging" deposits, in violation of section 21.[332]

Only 16 of the 50 NYSE firms in the FR–1 sample reported that they pay interest on free credit balances; the rates varied from 1 to 4 percent.[333] Explanations provided with the responses to FR–1 indicate that interest is usually paid only on large balances (the minimum amounts varied from $1,000 to $100,000), that it is paid only if the credit balances are reinvested within a short time, and that it is frequently paid only at the request of the customer. Interest on free credit balances, in short, is available primarily to large and sophisticated customers.

Whatever the real or imagined restrictions on paying interest on free credit balances, there appear to be no restrictions, except in a few jurisdictions [334] on the use of free credit balances for the purposes of the firm. All firms may use these balances to maintain positions in securities or otherwise in their general operations. Firms carrying margin accounts may use the balances to finance loans to margin

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[329] Customers' securities can be lent to other broker-dealers with much the same advantage for the lending broker-dealer as that derived from using free credit balances. Normally, the borrowing broker-dealer deposits cash in the amount of the full market value of the borrowed securities, and nowadays the loan usually is "flat," i.e., the borrowing broker-dealer pays no premium and the lending broker-dealer pays no interest on the deposit. The disadvantages in lending customers' securities are that certain written consents must be obtained and there may be some effort in finding another broker-dealer interested in borrowing the securities.

While free credit balances are, by definition, subject to instantaneous withdrawal by customers, a broker-dealer can count on a certain amount of stability and regularity of both the inflow and outflow of such balances. Merrill Lynch, for example, has estimated that roughly one-half of its large free credit balances represents "float," i.e., items which it will retain only for a brief period before transmittal to customers. The remainder represents amounts which it may hold for an extended period of time.

[330] 12 U.S.C. 378.

[331] S.E.C., Report on Investigation, *In the Matter of Richard Whitney*, v. III, p. 511 (1938).

[332] NYSE Rule 436 forbids members to accept deposits created for the purpose of receiving interest.

[333] Of the remaining 178 firms in the FR–1 sample, only 3 pay interest on free credit balances.

[334] See sec. 3.a.

customers; normally money is lent to margin customers at the going call-money rate plus one or one-half point. Although the firms' overhead cost of landing money cannot be readily determined, it is apparent that those using customers' funds have a considerable profit margin in such transactions.[335]

The importance of broker-dealers' loans to customers for purchasing or carrying securities is indicated by the fact that, at the end of December 1961, the net debit balances of customers of NYSE firms, secured by U.S. Government and all other obligations, were $4,298 million.[336] At the same date, the total of bank loans to persons other than broker-dealers for purchasing or carrying securities was $2,134 million.[337]

A large majority of firms responding to FR-1 indicated that they secure or attempt to secure instructions from customers with respect to remitting proceeds of sales of securities. The percentage ranged from 67 percent for members of the Amex to 86 percent for members of the regional exchanges and the NYSE; an aggregate of 185, or 81 percent of the firms in the sample, secure or attempt to secure such instructions.

Table III-e, below, shows the variation in practice when no instructions on remitting proceeds are obtained, as between firms which carry margin accounts and those which effect only cash transactions.

TABLE III-e.—*Practices of firms in FR-1 sample with respect to remitting proceeds of securities sales when no instructions are obtained*

[Number of firms]

Exchange membership	All sample firms	Firms carrying margin accounts			Firms not carrying margin accounts		
		Immediately [1]	Upon request	Other	Immediately [1]	Upon request	Other
NYSE	50	18	27	4	1		
Amex	15	3	3	3	2	4	
Regional exchanges	44	11	1	2	24	5	1
Nonexchange member	119	3	4		91	17	4

[1] Undoubtedly, the term "immediately" was interpreted in an elastic manner. It should also be noted that many of those replying in this manner stated that they rarely received interest and dividends on customers' securities, either because they rarely hold them or because they are registered in customers' names so that the interest and dividends were transmitted directly to the record owners.

Thus, among the 49 NYSE firms in the FR-1 sample that carry margin accounts, 18, or 36.7 percent, remit proceeds immediately when no instructions are obtained, while 27, or 55.1 percent, remit only upon request. At the other pole, 91, or 81.3 percent of the exchange nonmembers that do not carry margin accounts, remit immediately, and 17, or 15.2 percent, upon request.

A similar pattern occurs with respect to remittance of interest and dividends where no instructions are received. These results are shown below.

[335] For a discussion of the effect on broker-dealer income of the use of customers' free credit balances for lending, see ch. VI.

[336] Federal Reserve Bulletin, January 1962, p. 62.

[337] Federal Reserve Bulletin, November 1962, p. 1468.

TABLE III–f.—*Practices of firms in FR–1 sample with respect to remitting interest and dividends when no instructions are obtained*

[Number of firms]

Exchange membership	All sample firms	Firms carrying margin accounts		Firms not carrying margin accounts	
		Immediately [1]	Other	Immediately [1]	Other
NYSE	50	16	33	1	
Amex	15	5	4	4	2
Regional exchanges	44	11	3	27	3
Nonexchange member	[2] 107	5	1	88	13

[1] See table III–e, note 1.
[2] 12 firms in the sample indicated that they have never received interest or dividends on customers' securities, or did not reply to the question.

Thus, while firms that carry margin accounts are not alone in desiring to hold and use customers' free credit balances, the figures seem to indicate that the tendency is greater on their part.

b. Other cash equities of customers

For the sake of completeness, certain other customers' cash equities should be mentioned briefly. Since generally these are subject to the claims of broker-dealers holding them, technically they may not be described as "free credit balances." [338] These balances may exist in margin accounts: When securities in a margin account are sold, Federal Reserve Board [339] or various exchange requirements may prevent withdrawal of the proceeds. Similarly, a customer effecting a short sale may be required to deposit cash, or securities having an equivalent loan value, as protection in case of a rise in the price of the security sold short; the amount deposited is not available to the customer as a free credit balance. Finally, broker-dealers may hold large amounts of customers' cash balances covering transactions in process. This results from the fact that the public customers must pay broker-dealers by settlement date for securities they purchase, while the broker-dealer normally does not pay the selling side until he receives the securities. In the interval between payment by public customers and receipt of the securities from the selling side, the cash is available to the broker-dealer.[340] In the normal course of a securities business, such amounts flow through the broker-dealer's general cash balance and are available to him for such purposes as he deems desirable.

c. Customers' fully paid securities [341]

One of the functions which the securities industry performs is the holding of fully paid securities for customers. At the end of November 1962, broker-dealers held securities of their customers with a value estimated at $46 billion.[342] Some idea of the amount of the holdings of fully paid securities among broker-dealers in the Washington, D.C. area alone may be gained from the example of the 66 broker-dealers described above. Those broker-dealers, who, as noted, held more than

[338] In addition to the balances mentioned here, broker-dealers may receive funds as collateral for the customers' securities they lend. It appears that lending customers' fully paid securities, either listed or over the counter, is rather unusual.
[339] See ch. X.
[340] Certain problems resulting from late receipt and delivery of securities which affect broker-dealers' cash flow are discussed in pt. E, below.
[341] For definitions of terms used in connection with the holding of customers' securities and for a discussion of the manner in which they are held, see app. III–D.
[342] Hillery, "Street Name Securities," Wall Street Journal, Nov. 29, 1962, p. 18.

$6 million in customers' free credit balances as of March 31, 1962, at the same time held customers' fully paid securities with a value of more than $149 million.

Broker-dealers may hold their customers' fully paid securities for one or several reasons. From the customers' point of view, the holding of securities by broker-dealers is undoubtedly a convenience. In effect, it provides free safe-deposit facilities and, if the securities are held in certain manners described below, they may be transferred more conveniently than if they are in the owner's hands. From the broker-dealers' point of view, holding customers' securities serves as a means of retaining customer loyalty: If a customer decides to make a trade, some broker-dealers have expressed the view that he is more likely to do it through a broker-dealer who has retained possession of the securities. Many broker-dealers holding customers' securities look upon it as an expensive inconvenience but feel compelled by competitive pressure to provide the service, and virtually always without additional charge to the customers.[343] Of course, there are also many securities held only for limited periods after settlement date while awaiting delivery instructions from the customer.

The responses to FR-1 indicate that virtually all the firms in the sample hold customers' securities for safekeeping.[344] Information volunteered with responses to the questions indicates, however, that many small over-the-counter broker-dealers do not do so regularly, nor do they hold securities in safekeeping for as large a proportion of their customers as do the wire houses and many other exchange members.

d. Customers' securities in margin accounts

In addition to fully paid securities, broker-dealers often hold other securities of customers as collateral for debit balances in those customers' accounts. Such securities cannot be said to be held in "safekeeping," but if debit balances are adequately covered, certain of these "margin" securities may be "segregated" as a protection to the customer.

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[343] The practice of holding customers' securities in safekeeping as a "free" service has become a subject for considerable debate within the securities industry. A number of firms which hold great quantities of securities have become concerned with the cost of the service and at least one, Thomson & McKinnon, has decided to impose a $10-per-quarter service fee on all safekeeping accounts which are inactive for more than 24 months. Apart from the direct custodial expense, there are additional costs to broker-dealers resulting from the necessity to send proxy material and to credit interest and dividnds to the beneficial owners. See Hillery, note 342, p. 397.

[344] Among the firms replying to FR-1, the results were as follows:

Membership	Number which held customers' securities for safekeeping (and percent of class)		Number which did not hold customers' securities for safekeeping (and percent of class)	
	Number	Percent	Number	Percent
New York Stock Exchange	49	98	1	2
American Stock Exchange	14	93	1	7
Regional exchange members	42	95	2	5
Nonexchange broker-dealers	100	84	19	16
All firms	205	90	23	10

While it was not feasible to attempt to determine the value of all "margin" securities held by broker-dealers, it is apparent that their value is very great. An estimate might be derived from the aggregate debit balances of customers of NYSE member firms as shown by questionnaire OTC–3.[345] As of January 31, 1962, those firms accounted for an aggregate of $3,824 million of debit balances, an amount that was over 99 percent of all debit balances in margin accounts throughout the country.[346] The New York Stock Exchange requires that customers maintain margins (or equities) in such accounts equal to at least 25 percent of the market value of securities long and 30 percent of securities short.[347] If it is assumed that these provisions were being universally observed and, conservatively, that all accounts were at minimum margin maintenance levels, the value of cash and securities in the accounts must have been approximately $5 billion. However, the value of cash and securities in these accounts was undoubtedly far greater because the value of many securities in the accounts would have increased since purchase, and as for those which would have declined, member firms, as a matter of practice ordinarily "call" margin customers and demand more equity well before the minimum level is reached. Although a certain amount of the aggregate equity undoubtedly was represented by cash, a great proportion must have been represented by securities.

In summary, broker-dealers perform important custodial functions. In view of the control which they exercise over a customers' securities of great value, it is vitally important that these securities be adequately safeguarded.

3. EXISTING RULES, REGULATIONS, AND PRACTICES

There is a considerable body of financial responsibility rules governing segregation and use by broker-dealers of customers' funds and securities and requiring capital to be maintained proportionately to aggregate indebtedness.

a. Rules relating to free credit balances

Of the varieties of customers' assets which are retained in the hands of broker-dealers, free credit balances would surely seem to need the most protection. In the absence of any rules requiring segregation they may be, and often are, used for the general operating needs of the broker-dealer's business, for financing its trading and investment accounts or for loans to other customers to finance margin transactions. In the event of insolvency, the protection accorded customers' free credit balances even under the Bankruptcy Act is limited. Yet it is these balances that are accorded the least direct protection under other Federal or State law, or the rules of the self-regulatory organizations.

The Commission, in 1941, proposed that it be given power to require segregation of free credit balances by rule. The proposal, which was

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[345] See ch. VII.
[346] See ch. X.
[347] NYSE rule 431. Higher margins are prescribed for certain low-priced securities short in the accounts and, under certain circumstances, the margins for bonds short in the accounts must be greater than 30 percent. For a detailed description of the margin maintenance rules of the exchanges and the initial margin rules of the Federal Reserve Board Regulations T and U, see ch. X.

vigorously opposed by the securities industry, has never been adopted.[348]

Neither the exchanges nor the NASD require segregation. The NASD does "recommend" that its members either segregate deposits against "when, as, and if issued" and "when, as, and if distributed" transactions[349] or that they maintain aggregate bank balances equal to such deposits, but the recommendation is not a requirement. Indeed, implicit in the recommendation is the assumption that drawing down bank balances below the aggregate amount of customers' free credit balances is a normal procedure. It is a practice, however, that apparently is considered undesirable by a segment of the NASD's own membership[350] since 90 of the 228 respondents to FR–1 reported that they voluntarily maintain bank balances equal to or greater than customers' free credit balances; further, an additional 16 respondents to FR–1 reported that they voluntarily segregated free credit balances.

Under the laws of some of the States, specific restrictions do exist upon the manner in which customers' free credit balances may be held. For example, Iowa[351] requires that customers' free credit balances be segregated from firm accounts. Ohio requires that customers' free credit balances be segregated if the net capital of a broker-dealer falls below $10,000 or his "total indebtedness" exceeds 15 times his "net worth."[352] Apart from State law, however, there are no direct restrictions on the manner in which customers' free credit balances are held and used by broker-dealers.

Since the end of the Second World War there have been few instances in which the insolvency of a broker-dealer has resulted in heavy losses of customers' free credit balances. The case of Du Pont, Homsey & Co. and the action subsequently taken by the NYSE[353] have already been noted. In 1961, Pruett & Co., Inc., of Atlanta, Ga., a broker-dealer in over-the-counter securities and mutual-fund shares, failed, causing losses to customers of more than $2 million, including approximately $43,000 in free credit balances, virtually none of which was covered by a fidelity bond. Each of these instances resulted from fraud and defalcation by principals in the firm. In New York, Barrett, Herrick & Co., Inc., became insolvent in 1956 causing losses to investors of about $100,000 in free credit balances, approximately 25 percent of which was recovered in the ensuing liquidation. Generally, however, the solvency record of the broker-dealer community has been quite good and losses of free credit balances have been small in relation to the total number of investors in the country and the amount of their assets in broker-dealers' hands. Nonetheless, the mere fact that there have been any losses at all is sufficient reason to consider whether there are further adjustments that should be made for the protection of investors.

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[348] Report of SEC on proposals for amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, printed for House of Representatives Committee on Interstate and Foreign Commerce, 77th Cong., 1st sess., 29–32 (1941). The Commission has adopted rule 206(4)–2 under the Investment Advisers Act of 1940 requiring investment advisers to maintain separate bank accounts for customers' balances.

[349] NASD Manual, p. F–27. These transactions are purchases of securities which are not available for delivery. They comprise a minute percentage of all securities transactions.

[350] All broker-dealers in the FR–1 sample are members of the NASD.

[351] Iowa Code, sec. 502.13.

[352] Regulation DS–5, the Division of Securities of Ohio.

[353] See ch. II.B.

Segregating or otherwise safeguarding customers' free credit balances has been a subject of discussion for many years. At least two reasons may be advanced for requiring the segregation of free credit balances. First, it is argued that there are questions as to the propriety of broker-dealers' being able freely to use customers' funds. Second, it is argued that customers are not protected from exposure to loss in the event of broker-dealers' insolvency; and that segregation together with appropriate changes in the Bankruptcy Act would afford such protection.

On the other hand, since the Second World War, losses of customers' free credit balances resulting from fraud, defalcation, or insolvency have been small in comparison to the great volumes of transactions taking place and the number of customers in the market. It is apparent, furthermore, that rigidly denying broker-dealers the use of such balances would cause serious dislocation to a significant part of the securities industry. Use of free credit balances accounts for important additions to the income of many firms in the securities industry. Withdrawal of that source of income would have to be considered in the light of its effect upon the services now provided by the industry.

Certain protections for free credit balances, not now generally provided, are both desirable and feasible. Free credit balances are subject to demands for immediate withdrawals and broker-dealers have an obligation to maintain themselves in a position such that these demands can be met without resort to forced sales of securities or other undesirable means. In a similar situation, that of the member banks of the Federal Reserve System, the need has been met by requiring the maintenance of reserves equal to a percentage of demand deposits. Under current laws the Federal Reserve Board may set reserve requirements between 10 and 22 percent for "Reserve city banks" and 7 and 14 percent for "country banks." The rates in effect at November 1, 1962 were, respectively, 16½ and 12 percent. The requirement for Reserve city banks has been as low as 10 percent; that for country banks has fallen as low as 7 percent.[354]

It would seem desirable that broker-dealers likewise be required to maintain reserves of cash or Government obligations equal to a percentage of free credit balances. Although the question of percentage may be left for future determination, it would appear that a reserve requirement of about 15 percent would be feasible, would bear some relation to the requirements of Federal law for banks and would force broker-dealers to maintain themselves in a more liquid status than some do now. A further question is raised as to whether falling below this level should in itself be deemed a violation of applicable net capital rules. It is believed that this is not necessary, but that instead, where the difference between the aggregate amount of a broker-dealer's cash and Government obligations is less than 15 percent of his free credit balances, the difference should be charged against his net capital. Such a provision should be sufficient sanction against violation of the recommended rule.

Reserves and liquidity apart, customers are often unaware of the status of their free credit balances—that their free credit balances are

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[354] Federal Reserve Bulletins: December 1945, p. 1209; November 1962, p. 1457.

in fact being used by the firm holding them and that they are vulnerable in the event of insolvency.[355] The question may appropriately be raised whether broker-dealers should be entitled to use their customers' assets without notifying the customers or obtaining their specific consent. It is true that many broker-dealers send statements on a monthly basis to customers having open accounts, but it is also true that there are many broker-dealers who send statements irregularly or only upon request.[356]

It would seem desirable that broker-dealers holding free credit balances be required to render periodic statements of the amounts of such balances to their customers. Such statements should also inform customers of the status of the balances while held by the broker-dealer and of the customer's rights. Although such a notice would not provide protection to members of the public having free credit balances in the event of insolvency, it would provide adequate information for them to take steps to protect themselves.

b. Rules relating to segregation of securities

The rules of the NYSE express the basic aims of any system of segregating of securities as follows:

> When a member organization holds securities that have been fully paid for or holds securities in excess of the amount which can be pledged under rule 402 [see subsec. c, below] * * * , such securities should be segregated and marked in a manner which clearly identifies the interest of each individual customer (par. 2402.10 of NYSE Guide).

An appropriate segregation system is of great value in the administration of the rules governing hypothecation and lending of customers' securities.[357] Also, since "segregation" requires identification of customers' securities, following the rules may assure that customers of broker-dealers receive maximum protection in the event of bankruptcy.[358]

Neither the Commission nor the NASD have promulgated rules for general broker-dealers requiring segregation of customers' securities; the extent of the Commission's authority to adopt such rules under the Exchange Act is uncertain.[359] In 1941, 1956, and again in 1959, the Commission's legislative programs proposed amendments to the act in which such powers would have been conferred upon it. Those proposals, however, have not been enacted. Notwithstanding that they have no specific rules to enforce, both Commission and NASD examiners routinely check, in the course of regular inspections, whether customers' securities are segregated by the firms subject to their jurisdiction.[360]

A few States have adopted rules requiring segregation of customers' securities from firm securities. Among these are Iowa,[361] Michigan,[362] and Ohio.[363]

[355] See sec. 4.
[356] See sec. 1.e.
[357] See sec. 3.c.
[358] See sec. 4.
[359] The Commission by rule requires investment advisers to segregate customers' securities. See note 348.
[360] NASD Examiner's Handbook, items 15 and 70; S.E.C. Broker-Dealer Inspection Manual, pt. II.B.6.
[361] Iowa Securities Division Order No. 3 (May 20, 1949).
[362] Regulations, sec. 115, adopted pursuant to act 220, P.A. 1923.
[363] The duty is limited to broker-dealers not meeting certain capital requirements. Other exceptions are also provided; see note 352.

Certain exchanges, therefore, have adopted the major body of rules requiring segregation and identification of customers' securities. Under NYSE rules (which are more detailed than those of any other exchange), for example, customers' excess margin and fully paid securities must be physically separated from usable margin and firm securities and their ownership has to be identified in some manner. The "rule of thumb" that the NYSE follows is that stocks having a market value in excess of 140 percent of the debit balance in a customer's account should be segregated.[364]

The system by which securities are held and segregated may vary considerably with the type of firm. Many broker-dealers, especially those having extensive margin accounts, have concluded that holding securities in customers' names, segregated individually by customer, is inefficient and expensive. As a result, the NYSE, prior to the Second World War, developed the so-called "bulk segregation" system, under which securities may be held in street name. They are not "specifically identified" so that ownership of each certificate is known; rather, securities are segregated by issue, and each owner of securities of a given issue has an undivided interest, equal to the number of shares owned by him, in all certificates of that issue held by the firm. A record of ownership is maintained on cards which indicate all changes in ownership interests in the shares of that issue.[365]

The bulk segregation system is geared to large-scale operations, as is reflected in the responses to FR–1. Of the 48 FR–1 NYSE firms that hold customers' excess margin and fully paid securities, for example, 27 use the system. On the other hand, only 1 Amex firm, of the 14 that hold such securities, uses the bulk system; only 3 of 44 regional exchange members, and only 7 of 100 firms that are members of no exchange, use the system. Among the latter three groups, even those that carry customers' margin accounts and might therefore be expected to have more active businesses than firms that deal on a cash basis only, tend to use a method other than the bulk system of holding customers' securities.

Other firms use one of two other major methods of segregation, both of which result in "specific identification" of the ownership of given certificates. One is akin to bulk segregation in that certificates of each issue are held together; in this instance, however, there is affixed to each certificate a tab indicating the name or account number of the beneficial owner of the certificate. This method differs, too, in that the segregated securities may be registered either in the name of the customer or in street name. The other method simply identifies all of the certificates of each customer by placing them together in separate envelopes or folders or sometimes by merely identifying and clipping them together.

All of the methods described meet the requirements of the NYSE.

Among the other national securities exchanges, the Pittsburgh, National, and Pacific Coast Stock Exchanges require excess margin

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364 NYSE Guide, par. 2402.70, reads as follows:

"With respect to the segregation of customers' securities representing excess margin as required under rule 402(a) [par. 2402], a member organization should segregate that portion of the stocks in a customer's account having a market value in excess of 140 percent of the debit balance therein. The foregoing applies solely to a customer's account which contains only stocks. When a customer's account contains bonds, the basis upon which the organization is borrowing or can borrow on such bonds should be taken into consideration in determining the amount of securities to be segregated."

365 NYSE Guide, par. 2402.10.

and fully paid securities to be segregated and identified; [366] the Boston Exchange requires that fully paid securities be segregated and definitely marked as being held in safekeeping.[367]

Although formal segregation requirements do not cover a large number of firms in the securities industry, the responses to FR-1 and the activities of Commission and NASD examiners indicate the importance that is attached to segregating customers' securities. Without exception, those FR-1 firms that hold customers' securities in safekeeping stated that they segregate customers' securities and it is apparent that such segregation is regarded as sound brokerage practice.

Proper segregation reduces the likelihood of misuse of customers' securities. The danger is greatest in the case of securities in such form that they can be transferred by delivery. Thus, bearer bonds, securities in street name, or securities with executed stock powers attached, are potentially highly vulnerable to hypothecation and lending by firms in violation of the governing requirements.

The adoption of appropriate rules by the exchanges that have so far not adopted them, and by the NASD, would go far to protect the public. Until such action is taken, however, and to assure uniformity of standards, appropriate amendments of the Exchange Act should be adopted to empower the Commission to act by rule to require prompt identification of ownership and the physical segregation of customers' excess margin and fully paid securities. A Commission rule, like its capital ratio rule, presumably could exempt firms that, as members of self-regulatory bodies, are subject to a rule of at least equal stringency.

c. Rules relating to hypothecation and lending of securities [368]

The basic Federal rules relating to hypothecation of securities are found in the Exchange Act and Commission rules. For exchange members and broker-dealers who transact business through such members, section 8(c) and rule 8c-1 establish three basic requirements:

1. A customer's securities may not be hypothecated together with the securities of other customers without his written consent (sec. 8(c)(1));
2. In no event may a customer's securities be hypothecated with those of any person other than a customer (sec. 8(c)(2)); [369] and
3. In no event may customers' securities be hypothecated to secure an amount greater than the total owed to the broker-dealer by all his customers (sec. 8(c)(3)).

Under section 15(c)(2) of the act, which applies to over-the-counter transaction, the Commission has adopted rule 15c2-1, identical in scope and text with rule 8c-1.

The only Federal requirement with respect to lending or arranging for lending customers' securities is imposed by section 8(d) of the Ex-

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[366] Pittsburgh Stock Exchange, rule 37; National Stock Exchange, rule 3-20.09; PCSE, rule XI, sec. 3(k).

[367] Boston Stock Exchange Rules, ch. VII, sec. 3.

[368] When securities are hypothecated, they are pledged as collateral for a loan; the primary obligation is upon the pledgor to repay the loan.

When securities are lend, the borrower normally pays an amount equal to the value of the securities in order to protect the lender; the primary obligation is upon the borrower of the securities to return them upon demand.

[369] Thus, the securities of customers may not be commingled with those of a broker-dealer. The broker-dealer, however, may pledge his own securities separately as additional collateral for a loan on customers' securities.

change Act, which applies to exchange members and broker-dealers who transact business through such members and requires that written consent of the customers be obtained.

The foregoing sections of the statute and the rules have not been amended since their adoption and they would seem generally satisfactory to the extent of their coverage. In certain respects, however, they do not provide the public with complete protection:

1. An individual customer's securities can be hypothecated without his written consent, so long as they are not commingled with the securities of any other person and so long as the provisions of section 8(c)(3) are not violated.

2. Section 8(c)(3) establishes the maximum limit for which all customers' securities may be hyphothecated, but contains no limit on the amount for which the securities of an individual customer may be hypotheacted. Theoretically, for example, a broker-dealer owed $100,000 in margin accounts by all customers could hypothecate one customer's securities for that sum even though that one customer owed a much lesser amount. The undesirable results that are possible in the event of the broker-dealer's bankruptcy are discused below.[370]

3. Section 8(d) prohibits a broker-dealer from lending a customer's securities unless the customer's written consent has been obtained, but contains no limit on the amount of an individual customer's securities that may be lent. Thus, the same undesirable results in the event of the broker-dealer's bankruptcy are possible as in the case of a customer whose securities are hypothecated for a greater amount than he owes.

Some States, certain of the exchanges and the NASD have requirements with respect to the handling and use of customers' securities which supplement the provisions of the Exchange Act and the Commission's rules and increase the degree of protection accorded to the public. Rule 402(a) of the NYSE may serve as an example:

> No agreement between a member organization and a customer authorizing the member organization to pledge securities carried for the account of the customer either alone or with other securities, either for the amount due thereon or for a greater amount, or to lend such securities, shall justify the member organization in pledging or lending more of such securities than is fair and reasonable in view of the indebtedness of said customer to said member organization, except as provided in paragraph (d) [discussed below] of this rule.

This provision extends the protection of sections 8(c) and 8(d) of the Exchange Act in two ways. First, a member firm is limited in the amount that it can obtain by lending a customer's securities as well as by hypothecating them. Secondly, the firm is prohibited from hypothecating or lending a given customer's securities for more than is "fair and reasonable" in view of the customer's indebtedness to the firm: In practice, this means not more than the amount of the customer's indebtedness.

Other rules of the NYSE relating to lending of customers' securities also extend protection of these securities beyond that accorded by the Exchange Act and the Commission's rules. Rule 402(b) prevents any member organization from lending, either to itself as a broker or to others, securities which are held on margin for a customer and which may be pledged or lent under rule 402(a), unless a separate written authorization permitting such lending is first obtained from

[370] See sec. 4.

the customer. Consideration has been given in the past to incorporating the lending agreement directly into the Association of Stock Exchange Firms margin agreement, so as to avoid the necessity of obtaining two signatures in opening an acount, but aparently the NYSE has concluded that it is desirable to assure that margin customers receive special notice that their securities may be lent.

Rule 402(d), applying to excess margin and fully paid securities, requires that specific consent be obtained as to these securities before they can be lent to others or to the member firm itself as a broker, or can be delivered on a sale made by the firm for any account in which the firm or any partner or stockholder has an interest. This is a higher degree of protection than that afforded under rule 402(b); however, the required agreement relates to the particular block of securities, so that once a consent is signed it is valid until revoked and may be applied to any number of transactions. The rule nevertheless affords customers protection not otherwise provided and is salutary.

A rule of the Philadelphia-Baltimore-Washington Stock Exchange is substantially identical with NYSE rule 402.[371] There are rules of the American, Boston, Detroit, Pacific Coast, and Pittsburgh Stock Exchanges that require a "reasonable relationship" between the amount of a customer's debit balance and the amount for which his securities may be pledged or lent, but only New York and Philadelphia-Baltimore-Washington require a separate consent for the lending of usable margin securities.[372]

The NASD imposes a "reasonable relationship" rule, for hypothecation of securities but not lending, by section 19(c) of article III of the "Rules of Fair Practice":

> No agreement between a member and a customer authorizing the member to pledge securities carried for the account of the customer either alone or with other securities, either for the amount due thereon or for a greater amount, shall justify the member in pledging more of such securities than is fair and reasonable in view of the indebtedness of said customer to said member.

The statutes of a few States restrict the hypothecation of customers' securities. Consent must be obtained, for example, to hypothecate customers' securities against which there is no lien (including fully paid securities), or to hypothecate customers' securities for an amount greater than the amount of a customer's indebtedness, under the laws of Iowa, Michigan, Nebraska, and New York.[373] Many States, however, have no statutes with respect to hypothecation and lending of customers' securities.

The hypothecation and lending rules are intended to promote a high standard of administration and care of customers' securities. If bankruptcy does occur, the manner in which securities are held may have an important impact in that it determines the extent of customers' recovery under bankruptcy law. Bankruptcy problems are discussed in detail below;[374] it is sufficient to say here that the rules, in this respect, are valuable protection to the public.

Generally applicable rules similar to those of the NYSE would be desirable. Appropriate action by the other exchanges and the NASD

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[371] Rule 742.

[372] Amex Rule 412; Boston Rules, ch. VII, sec. 3; Detroit Rules, ch. XI, sec. 4; PCSE Rule X, par. 7 (a) and (b); Pittsburgh Rule 11.

[373] Iowa Code, sec. 502.17; Compiled Laws of Michigan (1948), ch. 451, sec. 132; R.S. Nebraska (1943), ch. 81, art. 3, sec. 343; New York Penal Law, sec. 956.

[374] See sec. 4.

could accomplish the desired result, but to insure both action and uniformity of standards, a Commission rule, perhaps one exempting broker-dealers subject to an equally stringent self-regulatory rule, is indicated.[375]

d. Net capital ratio rule

In addition to various minimum capital rules described in chapter II.B, there is a group of ratio rules that require that a broker-dealer's "aggregate indebtedness" never be more than a specified percentage of his "net capital," as those terms are defined. The rules are vigorously enforced [376] and of great value in assuring the solvency of broker-dealers generally.

The NYSE has had such a rule for many years and, when the Commission in 1942 adopted a similar rule, rule 15c3–1, it borrowed heavily from the exchange's pattern.[377] The Commission's rule requires, speaking generally, that "aggregate indebtedness" may not be more than 20 times as great as "net capital"; i.e., that a ratio of aggregate indebtedness to net capital must be maintained which is never greater than 20:1.

"Net capital" is essentially the net worth of a broker-dealer after making the following adjustments: adding debt which is subordinated pursuant to a satisfactory subordination agreement; deducting all assets not readily convertible into cash; adding and subtracting unrealized gains and losses on securities in the firm's trading and investment accounts; and subtracting a certain percentage of the market value of such securities (colloquially called a "haircut") ranging from 0 percent for U.S. and State Government securities to 30 percent for common stocks and preferred stocks, except for the senior preferred class of an issuer (if it is not in default). In other words, net capital means the liquid net assets of a broker-dealer reduced by certain percentages of the market value of most securities but including appropriately subordinated debt.

"Aggregate indebtedness" means, essentially, the money liabilities of a broker-dealer that are not adequately collateralized by his own assets, and that are not segregated in accordance with the provisions of the Commodity Exchange Act.[378] Also included are those debts that are not the subject of a satisfactory subordination agreement; however, liabilities on open contractual commitments [379] are omitted be-

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[375] It is not entirely clear that statutory amendments are required. It may be that action with respect to the over-the-counter market could be taken under sec. 15(c)(2) of the Exchange Act. Amendments proposed under the 1941, 1956, and 1959 legislative programs of the Commission, however, would have given the Commission specific authority to regulate hypothecation and lending both in the exchange and over-the-counter markets.

[376] See ch. XII.

[377] Rule 15c3–1 was adopted under section 15(c)(3) of the Exchange Act. The Commission has also proceeded against broker-dealers under section 8(b) of the Exchange Act which establishes net capital ratio requirements for members of national securities exchanges or those broker-dealers transacting business through members although the section has never been implemented by rule. In most cases tried under section 8(b), a net capital deficit existed by any standards so that the firms involved could not have met any net capital ratio test. In *Guy D. Marianette,* 11 S.E.C. 967 (1942), however, the Commission excluded certain securities which it believed had no ready market and which, in practice, had to be retained by the firm, in order to produce a net capital deficit. The Commission has generally chosen to proceed, in exercise of its powers, under rule 15c3–1.

[378] 7 U.S.C. 1–17a.

[379] Rule 15c3–1(c)(1)(H). Para. (c)(5) of rule 15c3–1 reads as follows:

"(5) the term 'contractual commitments' shall include underwriting, when-issued, when distributed and delayed delivery contracts, endorsement of puts and calls, commitments in foreign currencies, and spot (cash) commodities contracts, but shall not include uncleared regular way purchases and sales of securities and contracts in commodities futures; a series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment * * *."

cause the securities purchased are considered to be in inventory and thus are subject to a net capital "haircut." [380]

The net capital rule governs all registered broker-dealers except members of the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh Stock Exchanges; [381] and except those brokers who act solely as agents for issuers in soliciting subscriptions to the issuer's securities, promptly transmitting the securities and proceeds, and who hold or owe no customers' securities or funds.[382] Although the rules of the exchanges exempt certain of their own members, it would appear that virtually all registered broker-dealers having public customers are covered by a net capital rule.[383]

The ratio rules of the exchanges, the members of which are exempt from the Commission's rule, are the same in principle as that rule. The primary differences are the following:

1. Many exchanges have a fixed minimum capital rule as well as a ratio rule; a member of such an exchange must meet either the minimum capital or the ratio test, whichever requires a greater net capital;
2. The rules of the Midwest and Pittsburgh Stock Exchanges permit aggregate indebtedness to be no greater than 1,500 percent of net capital [384] (the rules of other exchanges prescribe a 20:1 ratio); and
3. The rules of certain exchanges prescribe greater "haircuts" on certain types of securities and also give the exchange authority to impose larger "haircuts" on securities than prescribed by the rules, if this for any reason is deemed advisable.

In addition, the NYSE has certain unpublished policies which have the effect of rules. While the 20:1 rule is the formal requirement of the exchange, upon occasion, when a firm has come close to this level, the exchange staff has "recommended" to the firm that in the future

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[380] As an example of the foregoing principles, let us assume that a broker-dealer has the following assets, liabilities, and capital:

Assets:	
Cash	$10,000
Government bonds	30,000
Common stocks in inventory	75,000
Common stocks on open contractual commitment	20,000
Furniture and fixtures	4,000
Real estate	6,000
Total assets	145,000
Liabilities and capital:	
Trade accounts payable	2,000
Customers' free credit balances	73,000
Liability on open contractual commitment	20,000
Capital	25,000
Subordinated loan	25,000
Total liabilities and capital	145,000

The net worth of the broker-dealer is $25,000 (his total assets less his liabilities including the subordinated loan). His net capital, however, is $21,500, since we add the amount of the subordinated loan and subtract 30 percent of the value of common stock in inventory (or $22,500) and an equal percentage of the common stocks on open contractual commitment ($6,000). Aggregate indebtedness is only $75,000 since both the liability on open contractual commitment and the subordinated loan are excluded.

Since aggregate indebtedness is only 349 percent of net capital, the broker-dealer is well within the 2,000 percent ratio of the Commission rule.

[381] Rule 15c3-1(b)(2) provides for exemption of members of these exchanges on the ground that their "* * * rules and settled practices are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule * * *."

[382] Generally speaking, the net capital rules of the exchanges exempt floor brokers and traders and specialists and any others doing business only with members or member firms. See for example NYSE rule 325.

[383] See ch. II.B.

[384] Rules, art. XX, rule 2, MSE; rule 47, Pittsburgh Stock Exchange.

it should maintain a ratio of aggregate indebtedness to net capital of 17.5:1. Similarly, the exchange staff sometimes exerts pressure upon member firms to keep inventories of securities at a value of not more than 10 times "excess net capital," i.e., the excess of the firm's net capital over the capital required to support its aggregate indebtedness under the ratio rule. Another "yardstick" used by the staff is that the value of positions in securities should not exceed twice net worth. Throughout the early part of 1962, the exchange urged its member firms to reduce their inventories, particularly in the more volatile over-the-counter securities. Notwithstanding these precautions, several member firms were in net capital difficulty following the market break on May 28, 1962, and the exchange's department of member firms later promulgated the following notice:

> Several member firms have been disciplined recently for violations of exchange net capital requirements, rule 325. Although each of the violations was relatively small in size, the exchange looks with extreme gravity on any failure to conform with its minimum net capital standards.
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> * * * * * * *
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> Most of the violations arose as the result of declining values of securities in proprietary accounts during the first half of the year. Most of the firms in violation held unlisted securities which were sizable in relation to their net capital, even though the exchange gave them small net capital credit. Consequently, in these cases failure to know the net capital position continuously led to the violations, as they could have been avoided by more rapid or earlier liquidation of some of these positions, or by additional capital contributions.[385]

Under the Commission's net capital rule, a broker-dealer carrying an inventory of common stocks with a market value of 10 times excess net capital, as defined, would suffer a net capital violation if the market value of the securities fell 13 percent.[386] This percentage varies inversely with the number of times the value of inventory is greater than excess net capital. Thus, if inventory is only 5 times excess net capital, a loss in value of about 30 percent must occur before there is a net capital violation, while if it is 20 times, a violation will occur with a reduction in value of about 7.5 percent.

There is no doubt that the "haircut" provisions of the net capital ratio rules are a salutary brake upon the accumulation of securities inventories. An NASD survey of its members as of June 30, 1962, prompted by the market break of May 28–30, demonstrated, however,

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[385] Department of Member Firms Ed. Cir. No. 165 dated Aug. 24, 1962.

[386] Assume, for example, that a broker-dealer, subject to the Commission's net capital rule, has the following assets, liabilities, and capital:

Assets:	
Cash	$75,000
Securities (common stocks)	50,000
Total assets	125,000
Liabilities and capital:	
Free-credit balances	40,000
Fails to receive	60,000
Securities (common stocks)	25,000
Total liabilities and capital	125,000

The firm's net worth is $25,000 and its net capital is $10,000 ($25,000 minus 30 percent of value of common stock in inventory, or $15,000). Since aggregate indebtedness is $100,000, the amount of capital required under the rule to maintain that indebtedness is $5,000 (5 percent of aggregate indebtedness). "Excess" net capital is $5,000, the difference between net capital and required capital; the market value of common stocks in inventory then is 10 times excess net capital.

If the value of common stocks falls 15 percent, or $7,500, net worth will be $17,500; net capital, however, will be only $4,750 ($17,500 minus 30 percent of the market value of the common stocks, or $12,750). Since required capital remains at $5,000, there will be a capital deficiency of $250.

that they are not completely effective. More than 95 percnt of the membership submitted financial statements that revealed 113 violations of the Commission's net capital ratio rule. The NASD has indicated that most of the violations occurred as a result of a decline in value of inventories in the break.

An attempt might be made to meet the problem of net capital violations caused by declining value of inventories by imposing "haircut" requirements even more stringent than those that now exist. The NYSE, in fact, does this from time to time on a case-by-case basis with respect to blocks of particular securities which, it is thought, may be large in relation to their market or to the size of the firm's net capital, but does not do so by means of generally applicable requirements. As has been indicated, the exchange may also establish upper limits upon the aggregate value of securities held by a member firm, in relation to the firm's net worth. The difficulty with such approaches, however, is that, while they may protect member firms' solvency, they may also hobble the making of over-the-counter markets by the firms when that function is most needed.

It would seem that a more flexible approach may be required, one that might both prevent net capital violations and encourage the market-making function. One possible approach might be a more flexible "haircut" rule, under which the Commission could increase the "haircut" for certain kinds of securities held by broker-dealers during periods of high speculative activity and rising prices, or decrease it in periods of market decline. Thus, broker-dealers could be inhibited more effectively than by the present rule in contributing to speculative rises, but could be given greater leeway to hold or increase inventories of securities rather than be forced to liquidate them in an already weak market in order to avoid a net capital violation. It is recognized that this suggestion may present significant problems of policy and administration, and no firm recommendation will be made with respect to its adoption at this time. Nevertheless, it is believed that such an approach should be further explored.[387]

4. PROVISIONS OF BANKRUPTCY LAW

a. Section 60(e) and related doctrines

The "operational" financial responsibility rules look primarily toward limiting and controlling the use of customers' assets by broker-dealers in the ordinary conduct of their businesses. In view of their ultimate purpose, however, it is appropriate to inquire how they operate in relation to the provisions of the Bankruptcy Act to protect customers in the event of insolvency.

Preliminarily, the background of the Bankruptcy Act provisions should be briefly stated. The rights of customers of bankrupt "stockbrokers," prior to certain amendments to the Bankruptcy Act in 1938, were formulated largely in cases involving the rights of margin customers. Their rights varied from State to State, with Federal bankruptcy courts applying the law of the jurisdiction in which the transactions at issue took place. Eventually two doctrines took form, the so-called Massachusetts and New York rules. The details of these

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[387] Further discussion of capital rules in relation to the market-making function appears in ch. VII.

rules, and the variants caused by differing fact situations, need not be elaborated in this report; only a brief explanation is needed.

The "Massachusetts" rule, followed in only a few jurisdictions, treated a broker who carried stock in a margin account for a customer as the owner of that stock. The parties were said to have an executory contract to purchase and sell the securities and their relationship was that of debtor and creditor. The customer was a general creditor.[388] Under the more prevalent "New York" rule, however, the courts held that a fiduciary relationship of pledgor-pledgee was created with respect to securities purchased on margin by a customer. If the customer could find similar securities in the possession of the stockbroker or of the person to whom the stockbroker had rehypothecated them, they could be reclaimed. If there were claims to a given class of securities greater than the supply of that class, the claimants shared pro rata. Thus, under the Massachusetts rule, customers' recoveries depended solely upon the amount of the stockbroker's assets that could be marshaled to meet the claims of general creditors. Under the New York rule, customers fared well or poorly depending fortuitously upon what securities could be found among the assets of the stockbroker or his pledgee.[389]

It was primarily to correct the inequities existing under the prevailing New York rule that section 60(e) of the Bankruptcy Act was enacted in 1938.[390] Section 60(e) in effect establishes three priorities for claimants to the assets of bankrupt "stockbrokers."[391] Under section 60(e)(2), the first level of priority is established for "cash customers"[392] who can "identify specifically" their property in accordance with the provisions of section 60(e)(4).[393] Such customers are entitled to reclaim their "property" in full. In the event a person who is a "customer" cannot qualify as a "cash customer" he becomes entitled to a share in a "single and separate" fund which is composed of—

> All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker * * *.[394]

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[388] See, for example, *In re Codman*, 284 Fed. 273 (D. Mass. (1922)).

[389] *Gorman* v. *Littlefield*, 229 U.S. 19 (1913). This does not purport to be a complete exposition of the law relating to claims of customers of bankrupt stockbrokers as it existed prior to 1938. For a more detailed exposition, see "Collier on Bankruptcy," vol. 3, par. 60.7[2] (14th ed. 1961).

[390] 11 U.S.C. 96.

[391] The term "stockbroker" is not defined in the Bankruptcy Act.

[392] Sec. 60(e)(1) reads, in part, as follows:

"* * * '[C]ustomers' of a stockbroker shall include persons who have claims on account of securities received, acquired, or held by the stockbroker from or for the account of such persons (a) for safekeeping, or (b) with a view to sale, or (c) to cover consummated sales, or (d) pursuant to purchases, or (e) as collateral security, or (f) by way of loans of securities by such persons to the stockbroker, and shall include persons who have claims against the stockbroker arising out of sales or conversions of such securities: 'Cash customers' shall mean customers entitled to immediate possession of such securities without the payment of any sum to the stockbroker; the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities; * * *."

[393] Sec. 60(e)(4) reads as follows:

"No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than 4 months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy."

[394] Sec. 60(e)(2).

Thus, all customers with provable claims share pro rata, ahead of other creditors, in a pool composed of the assets of all customers—less those of cash customers—held by the broker-dealer or reclaimable by him or his trustee. Their rights are not dependent upon the fortuitous circumstances in which the stockbroker's inventory is found or of the extent to which securities can be traced to the stockbroker's pledgee.

In the event that the "single and separate" fund is not sufficient to satisfy the claims of "customers," provision is made for the avoidance of transfers of customers' assets which would be void or voidable under the Bankruptcy Act and assets reclaimed in this manner become part of the "single and separate" fund; the transferees of these assets, if they were "customers," are entitled to share in the single and separate fund.[395]

Finally, assuming that the "single and separate" fund is still insufficient to satisfy all claims of "customers," they then share equally with the general creditors in all other assets of the bankrupt's estate. This is the third level of priority.

b. Problems arising from broker-dealer insolvency

It seems evident that section 60(e) is a significant improvement over the law as it formerly existed. Even so, it presents problems both of interpretation and of correlation with the financial responsibility rules.

Two main problems of interpretation exist. The first is the question whether the term "stockbroker," which is not defined in the Bankruptcy Act, means only those who buy and sell securities for their customers on an agency basis or also includes "dealers." In *Gordon* v. *Spalding*, 268 F. 2d 327, 330–331 (5th Cir. 1959), the court said:

> The history as well as the text of said § 60, sub. e(1) indicates clearly that it was intended to apply only to those who hold securities on margin and otherwise, not as owners, but as agents for their customers.

Thus, the test which the court established is the capacity in which the "stockbroker" has come into possession of a customer's assets; i.e., whether as a principal (dealer) or as agent (broker). It is apparent that this narrow definition could lead to strange results: If a "stockbroker" purchased securities for a customer as agent, was paid, and held the securities in safekeeping, the customer might be able to reclaim them. If, however, the same securities were sold to the customer in a principal transaction, section 60(e) might not apply and the customer, even though he had paid for the securities, would either have to find his identical certificates in order to reclaim them or become a general creditor. Clarification would obviously be desirable.

The second involves the ambiguous definition of the term "customer." A person who deposits cash with a broker-dealer against a purchase of securities that does not occur before bankruptcy might not qualify as a "customer" so as to qualify for the second level of priority.

Even assuming that the foregoing problems are resolved, questions of correlation with the financial responsibility rules would still exist. Segregation of securities, implementing the "reasonable relationship" rules, may permit many customers specifically to identify their securities and thus to reclaim them in the first level of priority. There may be considerable problems, however, where securities are held in bulk

[395] Sec. 60(e)(5).

segregation. For securities to be "identified specifically" one of two tests must be met: The securities must remain in their "identical form" in the "stockbroker's" possession until the date of bankruptcy; or the securities or substitutes therefor or proceeds thereof must have been allocated to or set aside for the customer, more than 4 months prior to bankruptcy or while the "stockbroker" was solvent, and must have remained so allocated or set aside until bankruptcy.[396]

The normal manner of operating the bulk segregation system unfortunately makes it impossible for securities to remain in their "identical form." Securities are removed from, or placed in, segregation as the day's transactions require, and securities certificates in segregation are regarded as fungible. It may be impossible for any one customer to say that certificates set aside for him remained in their identical form to the date of bankruptcy. Thus, a customer would not be entitled, as a cash customer, to reclaim securities held in bulk segregation, unless those securities were allocated to him more than 4 months prior to bankruptcy or while the broker-dealer was solvent. If the customer could not meet this requirement he would be entitled to share only in the "single and separate" fund, at the second level of priority.

A similar problem exists with respect to customers' free credit balances. Even if segregation of such balances were required, it seems clear that the ordinary practices of the securities industry would render it virtually impossible for a given customer to "identify specifically" a deposit of cash as his own. If a customer delivers a check to a "stockbroker" it could be said to be in its "identical form" if it remained uncashed at bankruptcy. Once it is deposited, however, it loses its "specific identity" and the customer is at best only a "customer" within the meaning of section 60(e). Thus, the only means by which a customer having free credit balances could receive protection as a "cash customer" in accordance with section 60(e) would be for the free credit balances to be allocated to, or physically set aside for, the customer in a special account, more than 4 months prior to bankruptcy or while the broker-dealer was solvent.

Finally, section 60(e) does not apply to receiverships. An insolvent broker-dealer can be placed in the hands of a receiver and be liquidated without ever going into bankruptcy at all. When liquidation is accomplished in this manner it appears that the old Massachusetts and New York doctrines may still have vitality and the capriciousness of result which section 60(e) was designed to eliminate may prevail.

A recent application of the New York doctrine occurred in *East* v. *Crowdus*, 302 F. 2d 645 (8th Cir. 1962), in which the petitioners argued that they had the right to reclaim certain shares of stock held in street name by a broker-dealer who was in receivership. The evidence showed that the claimants had ordered and paid for certain shares, that like shares had been purchased for the account of the broker-dealer, and that they were never specifically allocated to or set aside for the claimants. The claimants, relying upon the New York pledgor-pledgee doctrine, argued that they had traced the securities sufficiently to reclaim them by establishing that like securities to those they had purchased were on hand in an amount sufficient to meet their claim; in short, that securities of like kind are fungible when not specifically identified. The court supported their contention and permitted reclamation.

[396] Sec. 60(e)(4).

Although it would appear from the facts of this particular case that the claimants would have been entitled to the shares even if section 60(e) applied, slight variations in the facts could have caused the claimants to be reduced to "customers" at the second level of priority. This indicates the difficulty of developing a system which assures a fair result to all claimants against the assets of a broker-dealer. Nonetheless, if a broker-dealer properly segregated the securities of his customers, it is believed that there would be far less danger under section 60(e) that results of allocation of the broker-dealer's assets upon bankruptcy would be unfair, than if the Massachusetts and New York doctrines continued to have force.

Thus, there are broker-dealer bankruptcy problems still to be resolved. Amendment of section 60(e) to assure that "stockbrokers" include dealers having public customers, and to assure that those who transmit cash to broker-dealers for stock purchases are included in the definition of "customers" is indicated. The difficulty caused by bulk segregation could be resolved either by requiring specific identification, i.e., abandoning the bulk segregation system or by amending section 60(e) to include the bulk system among the types of "specific identification." As between the two possibilities, the latter would seem preferable. Bulk segregation is the only practicable system for many firms with large holdings of customers' securities and, in the event that a centralized handling system is instituted,[397] all securities of customers in the system probably would be held in that manner or a similar one.

5. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Many broker-dealers perform banking and custodial functions in the course of which they have custody of, and use, customers' assets of enormous value. The degree of dominion and control over customers' cash and securities may vary considerably depending upon the type of account which the customer has with the broker-dealer and with the amount, if any, owed by the customer to the broker-dealer. While many firms give regular notice to customers as to the status of their accounts, it would appear that there are many others which do not do so.

Customers' free credit balances are among the foregoing assets and may form a substantial part of the working capital of many broker-dealers. They are rarely segregated from broker-dealers' own funds. On the basis of prior loss experience, there does not appear to be a need to require complete segregation at this time. It would seem, however, that broker-dealers may reasonably be required to maintain an adequate liquid reserve against free credit balances, much as banks are required to maintain such a reserve against deposits. Furthermore, broker-dealers should be required to inform customers at regular intervals as to the status of their accounts.

Customers' margin and fully paid securities likewise are held in large volume by broker-dealers. Under the rules of the Commission, some States and certain exchanges, broker-dealers are restricted both in the use which may be made of those securities and in the manner in which they may be held. The rules presently existing are salutary to the extent of their coverage; the rules of the Commission and of

[397] See discussion in pt. E.

some of the self-regulatory organizations should be extended, however, so that they provide the fuller protection now existing under the rules of certain exchanges with respect to segregation and hypothecation and lending of customers' securities.

The net capital ratio rules of the Commission and certain exchanges have been a valuable protection for investors in preventing insolvency of broker-dealers. The current rigid "haircut" provisions of these rules, however, do not distinguish among broker-dealers performing different functions in the securities markets (except that exchange specialists and other members having no public business are not subject to such provisions), nor do they take account of changing circumstances in the markets. One result is that broker-dealers, including those making primary markets, may not be adequately restricted in accumulating inventories of over-the-counter securities during periods of price rises, but may be compelled to reduce inventories rapidly during periods of falling prices, contrary to market needs.

Section 60(e) of the Bankruptcy Act is a notable advance in the administration of broker-dealer bankruptcies. Nevertheless, there are within it certain ambiguities which should be resolved; furthermore, it is believed that customers whose securities or free credit balances are appropriately segregated should be entitled to greater protection than they are now accorded by section 60(e).

The Special Study concludes and recommends:

1. The net capital rules of the Commission and the self-regulatory agencies should be amended to require broker-dealers to maintain a reserve of, say, 15 percent of the aggregate amount of free credit balances in the form of cash or short-term U.S. Government securities; or in the alternative, if a lesser reserve is maintained, to charge the difference to net capital. In addition, broker-dealers holding free credit balances should be required to give customers at least quarterly notice of the amounts of such balances. Such notice should include information to the effect that their free credit balances may be withdrawn at any time; that while held by the firm they are not segregated and may be lent to other customers or otherwise used in the business of the firm; that interest is not paid on such balances (or the circumstances in which interest is paid); and that financial statements of the broker-dealer firm are available for inspection.

2. The Commission should be empowered to adopt rules requiring that excess margin and fully paid securities be segregated and marked in a manner which clearly identifies the interest of each individual customer.

3. The Commission should be empowered to adopt rules requiring that there be a "reasonable relationship" between the amount of each customer's securities that can be hypothecated or lent by the broker-dealer and the amount of indebtedness of such customer; and also requiring that broker-dealers obtain the specific, prior written consent of a customer before borrowing or lending his excess margin or fully paid securities.

4. Consideration should be given to the feasibility of providing greater flexibility in the so-called "haircut" provisions of the net capital ratio rules and in their administration, in order to take account of different functions, market circumstances, and needs.

Additionally or alternatively, consideration should be given to exempting specified quantities (perhaps 500 shares) of securities in the inventory of a "primary market maker" as defined in chapter VII.

5. Section 60(e) of the Bankruptcy Act should be amended to provide (a) that customers' securities that have been appropriately segregated within 4 days after receipt so that their ownership can be ascertained, whether or not specifically identified (e.g., the bulk segregation system), and customers' free credit balances if similarly segregated, will be considered to be "identified specifically" within the meaning of section 60(e)(4) notwithstanding that such segregation may have occurred less than 4 months prior to bankruptcy or during insolvency; (b) that the term "stockbroker" clearly include "dealers" as well as "brokers"; and (c) that the term "customers" include persons depositing cash for the purchase of securities. In addition, the Bankruptcy Act should be amended to empower the Commission to petition that an insolvent broker-dealer be adjudicated a bankrupt, so as to assure equitable treatment of claimants under section 60(e).

E. Delivery of Securities

1. "Fails to Deliver"

Many of the complaints received by the Commission and the NASD from the public concern late delivery or nondelivery of securities by broker-dealers. The New York Stock Exchange in August 1962 stated that one-fourth of the 1,200 complaints received by it in 1961 dealt with late delivery of securities.[398] In certain cases these may result from an intent on the part of broker-dealers not to effect prompt delivery.[399] Many more, however, result from "fails to deliver."[400] "Fails to deliver" is a technical term that means the failure of a broker-dealer to deliver a certificate in proper form at the agreed settlement date to another broker-dealer. The term is not used to indicate the late delivery of a security to a customer by a broker-dealer.

The broker-dealer's situation in regard to fails to deliver is revealed by two accounts in his books. His "securities failed to deliver" account indicates the dollar amount receivable for securities which he has not delivered at settlement date. In the normal transaction this is usually the fourth business day after the date of the transaction.[401] The "securities failed to receive" account, conversely, indicates the dollar amount of purchased securities which have not been delivered to him at the settlement date by other broker-dealers. For example, a customer of broker A sells 100 shares of XYZ; it is purchased by a

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398 NYSE Department of Member Firms, ed. cir. No. 164 (Aug. 14, 1962).

399 See ch. IV.B, where this problem is discussed in the context of restricting supply in new issues of securities. Also see Securities Exchange Act release No. 6778 (Apr. 16, 1962), in which the Commission made clear that failure of a broker-dealer to deliver securities to his customer on the settlement date in some situations is a violation of the antifruad provisions of the Securities Acts.

400 Study of the problems relating to "fails to deliver" was carried out by an examination of Commission files and the records of various self-regulatory organizations. Pertinent statistics, where available, have been used, but no statistics have been developed independently for this study. Conferences were held with a number of persons, including the officials of self-regulatory organizations, stock brokerage accountants, and back-office personnel of broker-dealers, to obtain their views as to the nature of the problems and possible solutions to them.

401 This is a general practice of the industry for "regular way" delivery. Regulation T prescribes that securities purchased in such a manner be sold out within 7 business days unless paid for or unless an extension of time is obtained. Regulation T, sec. 4(c)(8). See ch. X.

customer of broker B. On settlement date, which is the date on which broker A is to deliver the securities against payment to broker B, broker A is unable to make delivery. He will enter in his "securities failed to deliver" account the selling price of XYZ. At the same time, broker B will enter this amount is his "securities failed to receive" account.

At least one accounting firm is known to encourage its clients to attempt to keep the level of fails to deliver below that of fails to receive. The reason for this is clear. In the normal cash transaction, the purchasing public customer must pay his broker-dealer by settlement date. At the same time, that broker-dealer pays the seller's broker-dealer only upon delivery of the security. The purchasing customer's payment thus will be available to his broker-dealer for use in the business until the customer's securities are received. On the other hand, a customer who has delivered his securities for sale is entitled to payment by his broker-dealer at settlement date notwithstanding the failure of his broker-dealer to transmit the securities to the purchasing side. Since the broker-dealer failing to deliver does not receive payment until he transmits the securities, this decreases the money available for use in his business. An excess of fails to receive over fails to deliver, therefore, will result in a favorable cash flow.

A disadvantage of this practice is that, for purposes of the net capital ratio rules, fails to receive are included among the items of "aggregate indebtedness" and therefore must be supported by the firm's "net capital." [402] Under the Commission's rule 15c3-1, for example, net capital must be at least 5 percent of aggregate indebtedness, so that for each $1,000 in fails to receive the broker-dealer must have $50 in net capital, as the term is defined. Among broker-dealers of limited capital, this might either result in a limitation of their business activities or force them to demand delivery from the other broker-dealer so as to reduce their aggregate indebtedness.

Despite the inhibiting effect of the net capital rules, fails can rise to large amounts. For example, Merrill Lynch's latest annual report to the Commission, dated September 22, 1962, indicated that the firm's securities failed to receive account was more than $11,500,000. [403] The failed to receive accounts of many other broker-dealers amount to hundreds of thousands or millions of dollars at any given time. These amounts greatly increase in periods of heightened market activity. The NASD studied the rise in fails between December 31, 1960 and April 29, 1961, a period in which the market was exceedingly active, by canvassing its entire membership; 2,600, or more than half the NASD membership, responded. The results of the questionnaire are tabulated below:

[Aggregate dollar amount]

	Fails to receive	Fails to deliver
Dec. 31, 1960	665,348,000	657,067,000
Mar. 31, 1961	1,358,794,000	1,295,206,000
Apr. 28, 1961	1,530,478,000	1,491,379,000

[402] See ch. III.D.3.d for a discussion of these rules.
[403] This amount arose entirely out of customers' transactions rather than out of transactions for the firm's own account.

Many persons and organizations in the securities industry have become concerned that late deliveries of securities to customers might cause a loss of confidence in the industry among public investors. On April 26, 1960, for example, a notice entitled "Deliveries of Securities" was transmitted to members by the NYSE. It stated:

> The efficient transfer of securities requires that all persons involved in the transfer process carry out their obligations to effect deliveries, both to member organizations and customers, as promptly as possible. Failure to do so creates problems, not the least of which is the customer's concern when he does not receive within a reasonable length of time, certificates for which he has made payment.

Again, in August 1962, the NYSE said:

> A delay in the delivery of stock certificates may not be fully appreciated as significant simply because a delay does not cause a customer to suffer a financial loss. Many customers, however, wish to receive prompt delivery. This is particularly true of new investors who are accustomed to receiving other types of purchases at the time of, or before, payment. Some investors, too, want the psychological security of actually possessing their certificates. And in a few cases, concern over delayed deliveries can impair normal broker-customer relations—particularly among investors unfamiliar with auction market and member firm procedures.[404]

A member of the NASD, writing to Executive Director Wallace H. Fulton in 1961, said:

> It is gratifying that you are taking steps to do something about one of the worst abuses which has grown up in the forty years since I have been in the business. I refer to the deplorable condition relating to late delivery of securities.
>
> * * * * * * *
>
> Mr. Fulton, there is no one thing which is doing more to erode the public confidence, which was so recently restored to this business, than the laxity in making security deliveries.

The ability of firms to make delivery to customers inevitably is affected by fails and, where these rise to the amounts seen in early 1961, they may make proper servicing of members of the public impossible.

In addition, the finanical stability of broker-dealers may be affected by fails in a number of respects. The treatment of fails for net capital purposes and the effect upon a firm's cash flow have been noted. It should also be noted that fails increase the possibility of actual financial loss to broker-dealers. Assume, for example, that a public customer, X, sells to dealer A, who in turn sells to dealer B, who sells to dealer C, who sells to public customer Y. Such a situation is not uncommon in over-the-counter transactions. If the price of the security rises and dealer A fails to deliver and becomes insolvent, dealer B must purchase the security in the market at the higher price and without the possibility of recourse to dealer A, because he is still liable to dealer C who in turn is liable to Y.

James E. Day, president of the Midwest Stock Exchange, some years ago expressed the fear that, in a selloff, purchasers of securities might well attempt to void their purchase contracts where fails to deliver resulted in late deliveries of securities:

> It seemed possible that if [fails to deliver] kept on building up into the millions of dollars and we had a substantial selloff in the market, a purchaser who had failed to receive his certificate after a reasonable length of time might well be justified in voiding his contract which, of course, could be disastrous to any number of houses.

[404] NYSE, M.F. Educational cir. No. 164 (Aug. 14, 1962).

It should be noted that a number of procedures exist under the rules of the exchanges and the NASD whereby broker-dealers can protect themselves against financial loss (or at least limit their damages) and force delivery of securities. These include the "buy-in," "sell-out," and "mark to the market." [405] The buy-in is a procedure by which a broker-dealer purchases in the market, at the best available price, a security which another broker-dealer has failed to deliver. This has the effect of establishing the money amount of damages if the price of the security has risen over the initial contract price. The sell-out, conversely, is a procedure whereby a broker-dealer sells, in the best available market, securities which have been purchased and which the purchaser refuses, or is unable, to accept. In each case, the rules provide that notice be given to the defaulting party of an intention to buy in or sell out, as the case may be, so that the defaulting party can take appropriate action to fulfill the contract.

Care must be exercised to assure that the proper notice is given and that the buy-in or sell-out is properly executed or it will be invalid. Even so, it is possible that the opposite side may contest the validity of the buy-in or sell-out and thereby cause additional expense. Another disadvantage of the buy-in is that the broker-dealer who buys in temporarily ties up his own capital until the opposite side pays the money difference which is established. Furthermore, the market may be so thin that a fair buy-in price cannot be established.

Marking to the market is a less drastic remedy. It is a means by which a party who may be injured by failure to fulfill a contract demands that the defaulting party pay the money difference between the contract price of a securities transaction and the market price, as protection against a change in the price of the security. For example, if dealer A has sold 100 shares of XYZ to dealer B at 50, and then dealer A fails to deliver and XYZ rises to 55, dealer B can demand that dealer A mark the contract to the market by paying over $500. Thus, dealer B can buy the shares in the market at 55 without loss if dealer A's failure to deliver continues. However, if dealer A later delivers the shares, dealer B will return the $500 since a mark to the market does not change the contract price.

2. CAUSES OF FAILS TO DELIVER

Heightened market activity, with consequent increased workloads in back offices of broker-dealers and among transfer agents, undoubtedly is a major cause of fails.[406] Even at other times, however, the volume of fails may be considerable. There are a number of reasons.

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[405] See e.g., NYSE rules, pp. 165–168 and 281–294; NASD Uniform Practice Code, secs. 58–59.

[406] See, for example, the minutes of the NASD board meeting, May 1961, where the remarks of William H. Claflin III, then Chairman of the Board of Governors, were reported as follows:

"He went on to note that the health of the industry had been tested from time to time by frequent spot checks and that the most revealing of these was the 'fail to deliver' and 'fail to receive' position of member firms, and the percentage increases in those figures from the beginning of the year. The trend disclosed was a sharp initial rise as volume went up and then a leveling off, followed by a sudden change for the worse in April (1961). In spite of a somewhat decreased volume, the average 'fail' position in April showed an increase of approximately 35 percent. This rise, Mr. Claflin said, must be assumed to be the result of exhaustion in the back offices and that firms were unable to continue to handle the daily workload and were losing further ground. It was obvious, he said, that if this condition continued, action would have to be taken. Inherent dangers in this situation, he advised, included questions of how close firms were coming to losing control of their overall position; how much of the 'fail' rise was caused by short positions; and were firms already under water and unable to cover their positions?"

The lack of over-the-counter clearance facilities may result in transfers[407] which otherwise would be unnecessary. A hypothetical example was posed by the vice president of a life insurance company which acts as its own transfer agent:

> * * * [W]e will describe a hypothetical situation which is not at all uncommon. Let us assume that A, an individual, sells a sizable block of stock to B, an investment banker. B then sells the stock to C, another investment banker. C in turn sells the same stock to D, an investment banker located in New York. D sells the stock to E which is a large fund having its stock registered in the name of a nominee of a commercial bank. Since B does not want to disclose his customer, he requests the stock be registered in his name. He then delivers the stock to C, who has the stock reissued in his name. C delivers to D who has the stock reissued in his name and delivers to E. E then has the stock registered in his name. It will be noted from the above illustration that the same shares have been registered four times before being registered in the name of the ultimate investor. This is one of our problems and is one of the factors occasioning the tremendous volume of transfers we have had.

This problem may well be magnified by the greater likelihood that over-the-counter securities will be registered in a customer's name than will listed securities, which often are kept in "street name." Thus, a given over-the-counter transaction, even through clearance facilities, might require two transfers: one into the street name of the seller's broker-dealer and a second into the name of the purchaser. Nonetheless, were clearance facilities available, and were several of the transactions described above to take place on the same day, transmittal to the ultimate purchaser would be effected with fewer transfers than are now necessary.

The transfer process itself has been suggested as a partial cause of fails to deliver. A clearinghouse does not effect transfers: It serves primarily as a conduit for the delivery of securities in good form, and transferors and transferees are responsible for effecting such transfers as may be necessary. Delays may be caused by improper assignments of certificates by individuals or by trusts, estates, and corporations; these problems have concerned the NASD's Uniform Practice Committee for a number of years. Both the NASD and the NYSE have elaborate rules with respect to transfer of securities and the forms of acknowledgments that are required to constitute good delivery.[408] Often members of the public are inadequately informed as to the proper steps which they must take in preparing certificates for delivery, and the exchanges and the NASD have found it necessary to conduct an extensive educational campaign.[409]

[407] "Transfer" is the process by which the ownership of securities is transferred and by which this is reflected on a company's stock record book. A security in the name of a stockholder is transmitted to a "Transfer Agent," appointed by the company, which cancels the certificate and issues another in its place to the new owner of the security. Before being transmitted to the new owner or his agent, the certificate is sometimes first sent to a "Registrar" whose function is to assure that no more of a company's stock is issued and outstanding than is authorized.

[408] NYSE Rules, pp. 195–225; NASD Uniform Practice Code, secs. 31–38.

[409] The NYSE, for example, in the January 1962 issue of "The Exchange," published an article relating to fails which stressed the importance of promptly and properly effecting transfers. "The Exchange" followed this later in 1962 by preparing a "filler" for mailings to customers of member firms in which an effort was made to explain the reasons for delay in delivering certificates to purchasers. The first paragraph reads as follows:

"Securities transactions are normally settled between the two participating brokers 4 days after the trade date. During this time, the seller must deliver the certificate to his broker who makes a record of the transaction in his firm records, and forwards the certificate to us. Unfortunately, the seller does not always deliver the security on time, or correctly endorsed. This can delay the settlement process considerably, and is known in Wall Street parlance as a 'fail' to deliver. You can see the importance of your prompt delivery of share certificates when you are a seller."

Another cause of fails is the existence of "D.K.'s" ("don't knows"). These are trades which, at least temporarily, cannot be "compared" with the other party to the contract. "Comparison" is the practice of confirming transactions with the opposite party in order to assure that there is no misunderstanding as to the terms of a contract and in order to rectify any errors. Comparison is required under the rules of most exchanges and also under the NASD's Uniform Practice Code.[410] D.K.'s may arise for any number of reasons, including back-office errors and failure to obey the rules with respect to comparison of contracts.[411]

It has been suggested, also, that a part of the fails problem results from broker-dealers' short positions which they do not intend immediately to cover.[412] The NASD study to which reference was made above indicated, however, that a greatly increased short position was not a significant factor during the early months of 1961. Among those firms replying to the NASD's questionnaire there was a rise in fails to deliver, as already seen, from $657,067,000 to $1,491,379,000, or 127 percent, between December 31, 1960, and April 28, 1961. During the same period the book value of short positions rose only from $133,185,000 to $174,271,000, or 31 percent. Thus, while short sales with the intention to cover later undoubtedly cause some fails to deliver it cannot be stated with certainty that they significantly affect the overall volume of fails.

3. POSSIBLE MEANS OF REDUCING VOLUME OF FAILS TO DELIVER

The securities industry has been cognizant of the fails problem for many years, and a number of ideas have been advanced to meet it. Some would require minor revisions in the rules relating to closing of contracts, or the operations of broker-dealers, others would require the increased use of presently existing machinery, while still others would require a basic reorganization of existing securities handling, clearing, and delivery techniques.

During the rise in volume of fails in early 1961, the Uniform Practice Committee of the NASD considered three proposals: increased use of the buy-in procedure; temporary reduction of trading hours on a national basis to permit the back offices of broker-dealers to catch up; and revision of the NASD's rules to permit marking to the market on all contracts and partial delivery of securities.

Increased use of the buy-in might tend to reduce the volume of fails by encouraging defaulting broker-dealers to deliver. The buy-in is entirely voluntary, however, and tends to be viewed as a last resort by many broker-dealers because it is a double-edged sword: The broker-dealer who buys in another broker-dealer may find the procedure used against him in the future.

A mandatory buy-in procedure might encourage broker-dealers to "clear up" old outstanding items. If such a procedure were instituted, the period in which delivery could be effected before a buy-in would

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[410] See NYSE Rules, pp. 131–143; NASD Uniform Practice Code, secs. 9–11.

[411] The latter point was noted in the NASD News (December 1955): "Many members, the uniform practice committee said, are not sending out confirmations on the buy side of a contract. This not only makes it impossible to compare the trade properly, but contributes to many unnecessary errors that cost members money."

[412] See note 399, above.

become mandatory should be considerably longer than the normal settlement period; at least 30 days from trade date probably should be given. Extensions of time should be permitted for good cause upon request of the failing party. In the latter connection, it would be necessary to assure that extensions were not granted perfunctorily, as is often the case with extensions of time under regulation T, for payment for securities purchased.[413] A mandatory buy-in procedure would not solve the other problems surrounding buy-ins such as controversies over whether a contract existed, whether the buy-in was properly effected and whether a market existed in which a given security could be bought in at a fair price.

An alternative suggestion has been made that the rules of the self-regulatory organizations should permit unilateral cancellation of contracts under certain circumstances in which securities are not delivered. The rules of the NASD and the exchanges do not permit such a procedure [414] and the NASD Board of Governors, at its September 1959 meeting, rejected such an approach. Unilateral cancellation would be, to some extent, a sanction against late delivery. It would seem, however, that efforts to reduce the volume of fails might more profitably be directed toward encouraging fulfillment of contracts rather than their cancellation. Even when disputes arise under a contract, settlement through the processes of the governing organization would seem preferable to unilateral cancellation, wherever possible, both in terms of rendering service to the public and of the cost to the parties.

The second proposal considered by the NASD Uniform Practice Committee in 1961, a reduction of trading hours on a national basis during periods of high activity, was opposed by the NASD's Trading Committee. One of its members, in a letter to Executive Director Fulton, said:

> It is their unanimous opinion that each dealer should have the right to stop trading at any time he so chooses.
>
> I might add, however, that so far, the action taken by the New York security dealers to stop trading at 4 o'clock has noticeably slowed up trading after that hour.

It does not seem that restriction by the NASD of hours for over-the-counter trading would have any adverse effect upon any broker-dealer if it were required of all or specified classes of members, and it might assist in the reduction of fails to deliver.

In any event, the NASD Board of Governors has taken only limited action in this respect. In May 1961, at the height of the 1961 surge in market activity, the board of governors promulgated a notice to the membership in which it "strongly urged" that members suspend trading on May 29, 1961, commensurate with such action by the exchanges, due to the size of members' backlogs.

The third proposal, marking to the market on all contracts and permitting partial delivery of securities, involves some complex problems. Some persons think that marking to the market will encourage broker-dealers to effect delivery without the imposition of the more drastic remedy of the buy-in. The supposed benefit of partial delivery is clear; it might enable broker-dealers to clear more transactions than would otherwise be possible.

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[413] The granting of extensions of time under regulation T is discussed in ch. X.

[414] See note 405, above, where rules governing fulfillment of contracts and marking to market are cited.

At the present time NYSE members are permitted to mark to the market on all exchange contracts, but NASD members are not. Rule 165 of the NYSE reads in part as follows:

> The party who is partially unsecured by reason of a change in the market value of the subject of an exchange contract, may demand from the other party the difference between the contract price and the market price.

Rule 168 provides in effect that a party failing to comply with rule 165 may be bought in or sold out, as the case may be. Rule 58 of the NASD's Uniform Practice Code, however permits marking to the market only in the case of "when, as and if distributed" and "when, as and if issued" securities.[415] The uniform practice committee has rejected a proposal to extend the provisions of rule 58 to cover all contracts in securities primarily because it was felt that the financial position of smaller firms could be hurt and because such an immense amount of money could be tied up in marks to the market. It would seem, however, that a mark-to-the-market procedure, unless made mandatory, would be subject to the same practical limitations on its use as the buy-in procedure, and that the extension of rule 58 would probably not result in the large volume of "marks" predicted by the committee.

The Pacific Coast Stock Exchange has adopted a mandatory mark-to-the-market system with respect to fails which develop in its clearance operation. Fail items are marked to the market each day. In addition, each stock is watched and, where a short position has developed which is considered to be unduly large and has resulted in a volume of fails, steps are taken to borrow the security involved and a failing member is charged with the cost. Each member firm thus is encouraged to make delivery, and officials of the exchange believe that it has significantly reduced the volume of fails. The system, which makes use of modern data processing equipment, does not appear to have caused undue difficulty to members of the exchange and consideration might well be given to its adoption by other clearance operations.

The rules of the NYSE and the NASD also differ with respect to partial delivery. Rule 189 of the NYSE requires that a purchaser accept delivery "of any portion of a lot of securities contracted for or due on a security balance in lots of one trading unit [normally 100 shares] or multiples thereof." The remainder, under this rule, may be bought in. Section 15 of the NASDA's Uniform Practice Code states, however, that the purchaser shall not be required to accept partial delivery except in conjunction with a buy-in.

The Uniform Practice Committee of the NASD, at its April 24, 1961, meeting, unanimously resolved that no change be effected in section 15. It was thought by the committee that fails to deliver resulting from overloading of transfer agents (due to market activity) and short sales, would not in any event be aided by partial deliveries, that members' capital would be tied up by partial deliveries and that there would be certain mechanical problems. While certain of the difficulties envisaged by the committee do not seem well founded, on balance it seems doubtful that increased partial deliveries would contribute so significantly to a diminution of the volume of fails that they would outweigh other disadvantages which were noted.

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[415] See ch. III.D.3.a.

Various self-regulatory organizations, certain banks, and the Commission have considered the adoption of more basic changes in clearing, handling, and delivery systems than those described above. Such changes cannot be viewed solely in the light of present conditions. The New York Stock Exchange has projected a rise in volume from approximately 4 million shares per day at present to nearly 8 million in 1980.[416] To the extent that sizable increases in volume occur in that market and in other markets, changes of this nature would become increasingly important. One such change is the extension of clearinghouse operations, long used by the major exchanges, to the over-the-counter market; this has been undertaken by some banks and, quite recently, by the NASD. The purpose of any clearance operation has been described as follows:

> The basic principle of clearing operations is well understood. Where there are numerous transactions among a number of persons involving either the making and receipt of payments alone, or purchases, sales, and deliveries of fungible character, these numerous transactions can be quickly and economically handled if they are reported to a central agency, the transactions are matched and offset, payments are made and received of net balances only, and delivery transactions are combined to produce the minimum of deliveries of maximum size.[417]

Both the National Bank of Commerce of Houston and the Mercantile National Bank at Dallas have attempted to establish clearinghouses in which all members of the NASD in their area could participate. While the system of the National Bank of Commerce is no longer in operation, the Mercantile National Bank's clearinghouse includes many broker-dealers in the Dallas area and is operating successfully. The system is said to have resulted in a "considerable" speedup of deliveries in the Dallas area.

The NASD has caused the establishment of a National OTC Clearing Corp. The report to the board of governors in May 1961, of a special committee on over-the-counter clearing indicated the effect which such a corporation might have on fails to deliver:

> The thought most often expressed was that it [the OTC Clearing Corp.] would operate to minimize the number of failures to receive and failures to deliver now climbing to fantastic levels because of the activity of current security markets and the overloading of clerical staff available to handle it. Most of these dealers believe our present market will eventually level off, but that volume will never recede to the point when such facilities will no longer be necessary.

The clearance operation is to be confined initially to New York City; if successful, it may later be expanded by the establishment of branches linked by private wires in "key cities" throughout the United States. Banks, other financial institutions and broker-dealers which are members in good standing of the NASD are eligible to become clearing members. The corporation does not plan to use the automatic mark-to-the-market and stock-borrowing procedures of the Pacific Coast Stock Exchange.

A further step in the reduction of fails would be the elimination, to the maximum possible extent, of physical transfer and delivery of securities. The ideas which have been advanced along these lines have been largely in relation to the operations of the NYSE. They envision either a central securities depository or a central trust insti-

[416] NYSE annual report, p. 13 (1962).
[417] Prospectus, National OTC Clearing Corp. (June 4, 1962), p. 3.

tution. The latter would not only hold securities and record their transfer, but would also hold credit balances of customers of NYSE member firms. Both types of institutions, on instructions of member firms, would arrange margin loans to members' customers, permit pledges of securities held, and deliver securities out to customers, thus performing most back-office operations now performed by member firms themselves.

Two types of central securities depository systems have been suggested. In one, securities would be physically held in one place together with the associated records. In the other, the central depository would serve as a conduit through which the securities would flow to the appropriate transfer agents, who would hold them and make bookkeeping entries as to changes in ownership, delivering out such securities as were needed by firms or customers. Each system contemplates cross-pledging of securities by bookkeeping entry, upon order by member firms, so that no physical transfer of securities would would be required for that purpose. Transfers between firms likewise would not require physical delivery.

A central securities depository system has been considered at least since 1929. The Whitney investigation [418] in 1938, however, precipitated the first major inquiry into the feasibility of either a central depository system or a central trust institution. At that time, of course, the emphasis was sharply on protection of customers' assets. The NYSE, as part of its program developed as a result of the investigation, tentatively suggested that it establish a central securities depository for members which would receive, hold, and make deliveries of customers' margin, excess collateral and safekeeping securities.[419] The Commission agreed at that time that a central securities depository could be of assistance in separating the banking and brokerage functions of broker-dealers, and end which, in the light of the revelations contained in the Whitney report, appeared desirable. The Commission went on to say, however:

> * * * it is our view that the ideally effective measure for dealing with customers' free credit balances and customers' fully paid or excess collateral securities would be the establishment of trust institutions in various financial centers. * * * Such an institution would assume all banking and custodial functions now performed by brokers as an incident to their brokerage business whether conducted on a cash or on a margin basis. * * * Institutions of this character would have the advantage of placing centralized banking activities under appropriate supervision, reducing to a minimum financial risks to customers, and lessening the overhead expenses of individual brokers. Their use would also serve to remove customers' cash and securities from the risks of insolvency involved in the combination of the dealer with the brokerage function.[420]

In 1939, a four-member public examining board was appointed by the NYSE to consider further the problem of protection of customers' funds and securities and the advisability of establishing a central trust institution as suggested by the Commission. The board in its report on August 31, 1939, rejected the idea of a central trust institution on the grounds that it would involve reorganization of the industry at a time when it was operating unprofitably; there would be a duplication of existing recordkeeping machinery; it would

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[418] S.E.C., Report on Investigation, *In the Matter of Richard Whitney* (1938).
[419] Whitney report, v. I, p. 165.
[420] Id., v. I, pp. 171–172.

interfere with the confidential broker-dealer relationship; there was doubt that banks would lend on securities without physical transfer; and it was feared that concentration of securities in one institution would create various problems in regard to handling of proxies, removal of competition among brokerage firms in servicing customer accounts, danger to the market of concentrated selling from a single source, congestion at periods of maximum activity, and handling of margin accounts mechanically with no consideration of the credit worthiness of the borrower.[421]

The board also rejected the idea that the banking functions of brokerage houses be handled by banks on the grounds that handling margin accounts is a specialized business which can be more efficiently handled by the brokerage firms themselves and that separating custodial and margin-keeping functions would offer difficulties which would outweigh any other advantages.[422]

In 1955, however, a subcommittee on member firms' operations and exchange services of a special review committee on rules and procedures (the "Vilas committee") proposed a central securities depository and the views of the public examining board were refuted in a number of respects. The following points were advanced in favor of the adoption of such a system: Reduction in transfer volume with savings in costs of clerical help, space, stationery, stock record entries, messengers, bonding and security, and other miscellaneous matters; simpler loan procedures with pledging by bookkeeping entry rather than delivery of the collateral; simpler dividend accounting and proxy distribution; simplification of receipts and deliveries; potential savings in shipment costs and rehandling through possible direct shipment to clients by transfer agents; and potential savings in audit costs. An NYSE committee was formed in the same year to study means of reducing the large volume of securities processed in the street. The committee ultimately developed a plan called the pilot project for central handling of securities. Under this plan clearing members contributed blocks of certain stocks which were held in nominee name by the banks which acted as transfer agents for these stocks. NYSE transactions in these stocks resulting in net securities balances among clearing members were then settled, to the maximum possible extent, by appropriate bookkeeping entries through the central stock bookkeeping service which was operated by the NYSE Clearing Corp. for the pilot project. Provision also was made for cross-pledging of stocks in the system among the participating banks by bookkeeping entry.

After several limited trials, the final stage of the pilot project became operative in September 1961. Fifteen stocks were involved, five for each of three participating banks. All clearing members of the exchange participated. Between September 1961 and February 1962, when the plan terminated, 14 million shares were transfered without physical delivery of the securities, the number of certificates outstanding was drastically reduced, and issuance of proxies was accomplished with little difficulty. It thus would appear that the system is mechanically feasible.

The exchange is now engaged in a study of the results of the pilot project. A number of legal problems must be resolved and the eco-

[421] Report of Public Examining Board (1939), pp. 24–25.
[422] Id., pp. 25–26.

nomic feasibility of the system must be determined. A spokesman for a major NYSE member has expressed the view, however, that although temporary losses may be incurred, the centralized securities handling system will become so valuable in reducing physical transfers and in resolving back-office custodial and recordkeeping problems that the exchange community will be required to adopt it. From the point of view of reducing fails alone, it would seem that careful consideration should be given to the adoption of such a system not only in New York but also in other large financial centers.

The pilot project incorporates a number of ideas which have been advanced in relation to a central trust institution or a central depository. Transfers occur to the maximum possible extent by bookkeeping entry, deliveries are consequently reduced, the volume of certificates held by member firms is considerably reduced, and there is cross-pledging of securities. Thus, it would seem that at least some of the objections of the public examining board can be overcome.

Experience of the Midwest Stock Exchange also is worthy of note in connection with the doubts expressed by the public examining board concerning the undertaking of bookkeeping functions by a central trust institution. That exchange has adopted a centralized electronic bookkeeping system for its member firms which perform many of the functions ordinarily performed in the firms' back office. These include the calculation of information for confirmations (which are printed automatically in member firms' offices), and calculation of margin calls, margin balances, and transactions, among other items.

On November 30, 1962, 20 Midwest Stock Exchange member firms had been converted to the system and 10 others were in the process of being converted. While the system was operating at a loss at that time, the loss was less than had been budgeted and the exchange expects to attain a profitable level of operations in late 1963 or early 1964. This is a highly promising development and one that should be closely studied by similar organizations.

4. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The importance of encouraging prompt delivery of securities is clear. Late delivery to customers may render it difficult for them to sell when they so desire and may cause a loss of public confidence in the industry. Excessive "fails to deliver" may result in actual danger to the financial position of broker-dealers. Furthermore, the rise in fails to deliver in periods of heightened market activity suggests the danger that present securities handling, clearing, and delivery methods would prove inadequate to meet any sustained increase in volume. A "fails" situation such as that which arose in the spring of 1961 should not again be allowed to occur.

The volume of fails to deliver at any given time may well be reduced by revision of the present rules of the self-regulatory organizations or their affiliated clearing organizations to encourage prompt delivery. It is apparent, however, that these organizations should give increased attention to basic changes in present methods of handling, clearing, and delivery of securities and also to centralization of bookkeeping systems, in order to prepare for the expected increase in volume. A number of ideas have been advanced in this area for many years; their implementation is desirable.

The establishment of over-the-counter clearing facilities and the New York Stock Exchange pilot project for handling securities are promising developments. The Midwest Stock Exchange's centralized bookkeeping service, while not performing custodial functions, gives promising indication that centralized handling systems may be able to perform these functions.

The Special Study concludes and recommends:

1. The NASD should reconsider the adoption of rules under the Uniform Practice Code permitting marking to the market on a greater range of contracts than is now permitted. The experience of the Pacific Stock Exchange with respect to mandatory marking to the market appears to have been highly satisfactory and the self-regulatory organizations should consider the desirability of the adoption by them or their affiliated clearinghouses of rules requiring marking to the market for all clearinghouse transactions.

2. A requirement for mandatory buy-ins might be of material assistance in reducing the volume of fails to deliver. It is recognized, however, that the adoption of such a system might raise certain problems such as the unavailability of securities which could be bought in at a fair price. The self-regulatory organizations and the Commission should give further study to the feasibility and utility of such a requirement for various types of markets or categories of securities.

3. The NASD should promptly reconsider the adoption of appropriate rules which would permit the NASD Board of Governors to establish hours of trading for all members or for specified classes.

4. The industry, with the cooperation of the Commission, should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing, and delivery systems, with the goal of evolving institutions and procedures which would permit the reduction of physical transfers of securities and centralization of functions now performed by broker-dealer back offices insofar as possible.

F. The Broker-Dealer as Corporate Director

Among the many roles typically played by members of the securities industry, perhaps the one that is most fraught with subtle questions of obligation and potential conflicts of interest is that of director of publicly held companies. Quite commonly, a partner, officer, or employee of a broker-dealer firm serves on the board of an issuer whose securities the firm may have underwritten, for which it may be making an over-the-counter market, which it may be selling to its customers or recommending to its advisory clients, or in which the firm or its principals may have an equity interest. It is the purpose of this part of chapter III to discuss the nature and extent of directorships held by broker-dealers and problems which may arise from these multiple relationships.

1. THE PREVALENCE OF BROKER-DEALER DIRECTORSHIPS

In questionnaire OTC-3, every registered broker-dealer firm in the United States was asked to report the number of directorships in publicly owned companies held by officers, directors, partners, or employees of the firm.[423] Of 4,964 firms replying to the questionnaire, 476 stated that members were directors of one or more companies whose stock was traded on an exchange, and 995 that they were directors of one or more companies whose stock was traded only over the counter. Many of these firms had only one or two directorships, but 101, including several of the largest underwriters and commission houses, were represented on the boards of at least 10 companies.[424] For example, members of Bache & Co. were directors of 23 listed and 29 over-the-counter companies; Kidder, Peabody & Co., 23 listed and 29 over-the-counter companies; Lehman Bros., 58 listed and 23 over-the-counter companies; and Paine, Webber, Jackson & Curtis, 24 listed and 29 over-the-counter companies. In addition to these large, well established firms, several of the newer and smaller underwriting houses which specialized in bringing out new issues in recent years had members on the boards of directors of several over-the-counter companies. For example, Globus, Inc., had 17 such directorships.

2. REASONS AND MOTIVATIONS

Most broker-dealer directorships arise out of underwritings of securities. This is made clear not only by the statements made by a number of broker-dealers interviewed by the Special Study, but also by the study that was made of 22 new issues of stock offered to the public during the years 1959 to 1961.[425] In each of the 22, a representative of the managing underwriter was on the issuer's board of directors prior to the public offering, or the underwriting agreement provided that the issuer would use its best efforts to elect a representative of the underwriter to its board.

Most managing underwriters who were interviewed or who submitted statements to the Special Study expressed the view that service on the boards of directors of issuers whose securities they offered to the public constituted a part of their responsibility as underwriters. They stated that they felt a continuing obligation, which survived the completion of the offering, to the issuer, to their customers who became stockholders, and to the other underwriters and their customers. These broker-dealers stated that, as directors, they acted as "watchdogs" who would keep an eye on the issuer during its first years as a publicly held company, for the benefit of both the company itself and its stockholders. The president of Wagenseller & Durst, Inc., a Los Angeles firm, put it this way:

> We do not believe that reputable investment banking houses are willing to accept the responsibility of underwriting and sponsoring the initial issuance of securities on the over-the-counter market by small and financially unsophisticated corporations unless a representative is placed on the board who will be in a position to check on the activities of the company and guide it in fulfilling its responsibilities as a "publicly held corporation," at least during a period of several years after it has first "gone public."

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[423] Questionnaire OTC–3 is attached as an appendix to ch. VII.

[424] In questionnaire OTC–3, broker-dealer firms were not asked to state whether their partners, officers, directors, or employees who were serving as directors of publicly held companies were doing so as representatives of the firm or in their individual capacities. The phrase "representation on the board of directors" and similar terms used here are meant only to indicate that individuals were serving in a dual capacity, without any implication that they were serving as delegates of their broker-dealer firms. In this connection, see *Blau* v. *Lehman*, 368 U.S. 403 (1962).

[425] See pt. B of Ch. IV.

An officer of Hayden, Stone & Co., Inc., stated:

> * * * [W]e felt we had a responsibility to the public to keep these managements oriented to what their public responsibility is and this is a very serious problem here with so many new companies coming to the market, in areas of acquisitions, dealing with the stockholders, annual reports, proxy statements, regularity of directors' meetings, * * * We have to help them through the period of learning that they are no longer a private company, but now have public responsibilities.

In a similar vein, a senior partner of Shearson, Hammill & Co., although generally minimizing the necessity for serving on boards of directors, stated:

> There is one area, however, in which a position on a board of a relatively new or small enterprise may be desirable, and that is for the help which such member can be in guiding such a company correctly in its operations and its responsibility to stockholders. My own experience has been that the contribution I have been able to make in this general purpose has been of importance to management and stockholders.

Other expressions of similar tenor appear in part B of chapter IX. It was emphasized that the underwriter as director of newly underwritten companies can insure that stockholders receive adequate corporate information and that other obligations of publicly held companies to their stockholders will be properly recognized. Some broker-dealers indicated that after a 2- or 3-year period during which the issuer became "more stockholder conscious," serving on the board might no longer be necessary.

Measures other than board representation are available and customarily used in order to assure an adequate flow of information to shareholders, even in the earliest years after a first public offering. It is quite usual for underwriting agreements to include a requirement that the issuer furnish periodic financial reports to the managing underwriter or to shareholders, whether or not a representative of the managing underwriter is placed upon the board of directors. In 6 of the 22 new issues which received intensive study,[426] the issuers were required to provide such information to their shareholders, and several others had informal agreements with their underwriters to the same effect. The Shearson, Hammill partner quoted above pointed out, in emphasizing the broker-dealer's role in assuring adequate disclosure, that the enactment of legislation requiring over-the-counter companies to file periodic financial reports—which he strongly advocated—would serve to minimize the need for broker-dealers to sit on boards of such companies.[427]

Apart from the underwriter's role in protecting stockholders of a newly public company, many spokesmen have stressed the contribution which a partner or officer of an investment banking firm can make in providing general business judgment and advice, and particularly in giving financial advice, to a corporation. A partner of White, Weld & Co. said:

> The value of the relation of having one of our partners or people on their board is that they feel they often have very helpful ideas to contribute to their meeting.

A partner of Kidder, Peabody & Co. characterized service as a director as "* * * an additional service to the company in connection with our

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[426] See above and pt. B of ch. IV.
[427] See ch. IX for a discussion of these legislative proposals.

investment banking relations." A memorandum prepared by W. Yost Fulton, senior partner of Fulton, Reid & Co., Inc., a Cleveland broker-dealer firm, for the use of members of that firm serving as corporate directors, gives a detailed picture of the services that a broker-dealer can perform on behalf of public corporations. Among the subjects upon which he may bring his expertise to bear in order to assist management are dividend policy, stock splits, the advisability of listing on an exchange, debt structure, sale and lease backs, and the use of excess corporate funds. In addition, he can advise and keep a check on the amount and form of executive compensation and, in general, can act as a sounding board for the ideas of the company officers.

There is no reason to doubt that many investment bankers perform valuable services in these and other areas particularly in the case of, but not necessarily limited to, companies whose managements are inexperienced in financial matters or relations with public stockholders. According to some broker-dealers, it would be impossible to perform these services without board representation. For example, a partner of Kidder, Peabody & Co. said:

> There are questions which arise at a board meeting as to which it is invaluable to have the judgment of an experienced outside individual, a person with general, broad business experience, such as investment banking individuals have.

On the other hand, some firms believe that, even where they feel special obligations by reason of a past underwriting relationship, they can provide issuers the advice and guidance that they need without board representation. Even the senior partner of Fulton, Reid & Co., Inc., who is one of the most articulate proponents of broker-dealer directorships generally and whose views are reflected above, does not insist that there be investment banking representation on the boards of companies that his firm underwrites, but only that at least two "strong outside directors" be elected, who may be commercial bankers or other businessmen.[428]

Looking at the other side of the coin, there is no doubt that board representation may also be of benefit to the broker-dealer firms themselves. Among the incentives that have been cited by members of the industry for going on boards of directors are the establishment of a close relation with a company in order to obtain future underwriting business from it,[429] the contacts that can be made for the purpose of obtaining other new underwriting business, the enhancement of their reputation in the industry which will come from insuring that the company is a success, and the opportunity to learn about different businesses and about the economy in general.[430] In some instances, the possibility of access to information which may assist the firm in its

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[428] In a similar vein, the New York Stock Exchange urges listed corporations to have at least two outside directors. NYSE Company Manual, B–23.

[429] It is noteworthy that, in order to discourage such continuing relationships, registered public utility holding companies and their subsidiaries are not allowed to have investment bankers on their boards of directors, unless exempted by a rule of the Commission. Public Utility Holding Company Act of 1935, sec. 17(c). Similar prohibitions on investment-banker directorships of utility companies are contained in other Federal and State statutes.

[430] Chamberlain, "Why It's Harder and Harder To Get a Good Board," Fortune, November 1962, p. 109.

In this connection, a partner of Lehman Bros. told the Special Study: "Now as to why we want to become directors: No. 1, we think if we are going to be of substance in the financial community we ought to know as much as we can about the affairs of the country and by being on the boards of companies we do get information not only on the affairs of the companies but what is going on in the economy. We think that that helps us to be better bankers."

trading and retailing activities apparently also provides a motive for going on the board.

On the other hand, some firms avoid directorships entirely, and in the course of the study several firms expressed reluctance to have their members or employees serve on the boards of companies. The principal reasons given were the large amount of time required to perform such duties and the impossibility of obtaining adequate compensation. A partner of one prominent firm stated that the firm turned down four directorships for every one accepted. An officer of another stated that the principals of the firm "generally resisted going on boards where he could get away with it without having the companies' feelings hurt." A partner of still another firm expressed similar reluctance but stated that it was rare for the firm to decline a request to serve on the board of a company if customers of the firm held substantial amounts of the company's stock.

3. POTENTIAL CONFLICTS OF INTEREST

Reluctance of many broker-dealers to serve as corporate directors is partly due to an awareness that conflicts of interest may arise when this function is combined with many of the normal activities of the securities business. For example, Gregory & Sons avoids making markets in securities of companies upon whose boards the firm is represented, since "there well could be" a conflict. A partner of White, Weld & Co. told the Special Study that his firm tries to avoid putting its fee-paying investment advisory clients in stocks of companies upon whose boards members of the firm sit:

> I think the manager of our investment department has found that life is just too complicated if he has his investment advisory accounts where we have a very close affiliation, either a member of the board or otherwise.

This consciousness of the potential problems connected with the holding of directorships was undoubtedly sharpened by the 1961 decision of the Commission in *Cady, Roberts & Co.*[431] In this case, the Commission ruled that the antifraud provisions of the securities laws had been violated where a partner of a broker-dealer firm entered transactions in a listed security for his wife's account and for discretionary accounts of customers, on the basis of advance knowledge of a reduction in the company's regular dividend, received from an employee of the broker-dealer firm who was a director of the company. The Commission stated:

> * * * [I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which if known would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the antifraud provisions. If, on the other hand, disclosure prior to effecting the purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.

The Commission took the position that the obligation to make such disclosure—

> rests on two principal elements: First, the existence of a relation giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

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[431] Securities Exchange Act release No. 6668 (Nov. 8, 1961).