NEW YORK STOCK EXCHANGE
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June 1, 1971

The Honorable William J. Casey
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Dear Chairman Casey:

We appreciate the opportunity to respond to your letter of April 27 asking for our comments on a listing of "unsafe and unsound practices of broker-dealers" to assist the Commission in responding to Congress in accordance with the mandate included in the SIPC legislation.

First, your letter asks for a statement of the steps which the Exchange has taken in the past to eliminate such practices. Rather than detail and restate the various rules and regulations which the Exchange has adopted in the past several years, all of which is available in the Commission files, we have prepared the enclosed listing (Exhibit A) of the Constitution and rule changes which the Exchange has adopted since 1967.

Second, as to those actions which the Exchange is considering taking, the most important step in this area is the proposed revisions in the Exchange's capital rule, Rule 325. Since these proposals are the subject of current discussions between us, we see no point in restating our proposals in the capital area in this letter.

Third, with respect to a detailed list of practices which we think are unsafe or unsound, it seems to us that there are certain basic areas which need to be addressed by the Exchange and the Commission. These basic areas of concern are as follows:

1. Improved Capital Base of Broker-Dealers

The Exchange has taken important steps to improve the capital base of member organizations. Essentially, these include the adoption of comprehensive proposals permitting public ownership of member corporations and the improvements in the Exchange's capital rules.

These two developments will have a profound favorable impact on improving the permanency of capital in member firms. The Commission, it seems to us, should be moving to do the same with respect to non-member broker-dealers as the capital base in many non-member firms is often inadequate.

We are constantly reviewing what more the Exchange might do to upgrade the permanency and quality of capital in member organizations. Whether this will require new Exchange regulations is not clear to us at the moment.

2. Free Credit Balances

We are aware, of course, that Section 7(d) of the Securities Investor Protection Act of 1970 mandates the establishment of Commission regulations with respect to free credit balances and related areas.

As was pointed out at our recent meeting on this subject, this is an extremely sensitive area both in terms of impact on the financial operations of broker-dealers and their customers. We are currently, in conjunction with other industry organizations, studying all aspects of free credit balances and will be reporting back to you as per our discussion.

3. Segregation of Customers' Securities

The matter of the segregation of customers' securities is another area that may give rise to "unsafe and unsound" practices in the context of the Congressional use of those terms. We are currently reviewing what else the Exchange may do in this area by way of strengthening existing segregation rule – Exchange Rule 402 – and our enforcement of it.

The Commission might consider establishing its own segregation rule for non-member broker-dealers.

4. Trading Practices

The trading practices of some customers of broker-dealers, particularly some institutional investors, have subverted the existing securities markets to the disadvantage of public investors. In some instances, such as the use of reciprocal devices of an infinite variety, the ultimate impact has undermined the structure of the securities industry.

This is an area which requires the Commission's urgent attention as it cannot be dealt with by one Exchange acting unilaterally. The Commission acknowledged this by a letter to me of September 4, 1968, from Irving Pollack which stated, in effect, that the SEC would enforce the ban on customer directed give-ups on all exchanges. We all are aware of the gimmick type practices which have continued to develop and where these practices have been used to promote the self interest of one

organization to the detriment of the entire structure of our securities markets. The Commission should consider whether, among other things, institutional trading should be subject to regulatory restraints and should move to ban reciprocal practices.

5. Automation of Securities Trading

Much has been said and written in recent months concerning the automation of securities trading. The question of unequal or disparate regulation in this area is one which the Commission must address in a review of unsafe and unsound practices. It is axiomatic that in time broker-dealers will move their trading to the least regulated market, particularly if this is in the self interest of the broker-dealer. It does not follow that this is in the public interest, nor does it follow that this trend, if accelerated, will take place in an orderly fashion with appropriate safeguards. The Commission proposed, but has never adopted, minimal reporting requirements with respect to automated markets.

The Exchange will be expanding its own automation programs in the coming months and we will build into our systems necessary regulatory safeguards. The Commission should see that the same course is followed with respect to other automated systems.

6. Auditing Procedures

Another question related to the entire issue of member firm capital requires the serious attention of the securities industry, the Commission and the accounting profession. This is the adequacy – or inadequacy – of present practices in brokerage auditing.

The serious deficiencies in audits and reports greatly complicated the identification of capital problems at brokerage firms during 1969-70. One problem centers on the availability of adequately qualified personnel to conduct audits of brokerage firms. Another concerns the adequacy of existing accounting standards. A third involves the business relationships which exist between major independent public accountant firms and their brokerage firm clients.

We understand that the Accounting Principles Board of the AICPA currently is looking into ways of improving certain specific practices in brokerage accounting. The existing problems may go farther and deeper than the scope of the Accounting Principles Board's current inquiry. We are tempted to raise the question, for example, of whether the present degree of reliance on the accuracy of an audited statement – which is virtually 100% -- is appropriate in view of the experiences of certain brokerage firms in the recent past. We have also begun to consider whether it might be appropriate for the Exchange, in the future, to assume a role in assigning independent public accountants to conduct audits at individual member firms, regardless of other business relationships which may exist between individual brokerage and accounting firms.

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In closing, I might point out that in view of the continuous – and often rapid – changing circumstances in the securities industry it is difficult to say unequivocally that one has dealt with or is aware of all of the practices which might be subsequently determined to be within the description of "unsafe and unsound." The best we can do as self regulators is to try and discern such practices as they begin to develop and move to deal with them before it is too late. This is what we have done and what we will continue to do in carrying out our self regulatory responsibilities.

Very truly yours,

[(Signed) Robert W. Haack]

Encl.

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