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REVIEW OF SEC RECORDS OF THE DEMISE OF SELECTED BROKER-DEALERS

STAFF STUDY

FOR THE

SPECIAL SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
SPECIAL SUBCOMMITTEE ON INVESTIGATIONS,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., May 17, 1971.

DEAR CHAIRMAN STAGGERS: It is my pleasure to forward to the Subcommittee a staff *Review of SEC Records of the Demise of Selected Broker-Dealers.* This review was undertaken as preliminary to a comprehensive study of the entire industry.

In summary, the review disclosed the necessity for a comprehensive study. It revealed that the industry is beset by a number of serious complex problems that do not have simple solutions. In this regard it was noted that there was no common cause for the failure of the broker-dealers. Although each instance was finally recorded as a capital deficiency, the underlying problems included operational losses, mismanagement, market decline, back-office difficulties, inoperable and/or overly expensive modernization programs, insufficient initial capitalization, and fraud. In most instances the cause of these problems could not be determined.

The review identified a number of problem areas within the securities industry and the applicable regulatory functions which should be improved. These include the eligibility requirements and examinations for becoming a broker-dealer, current standards of financial requirements, timely inspections and detection of financial and operational problems, and administrative or disciplinary actions. By no means are these problem areas considered to be all-inclusive.

This review, by necessity, was very limited. For example, no consideration was given to the more serious and complex problems of allowable and/or negotiable commission fees, eligibility requirements for membership on exchanges (especially the admission of institutions and capitalization), feasibility of eliminating or adopting uniform machine-readable stock certificates, uniform accounting system, safeguards for theft prevention, failure of broker-dealers to receive and/or deliver securities, clearing procedures, etc. Certain problems, such as the impact of institutional investors, back office problems, and commission rates have been the subject of separate major studies by the SEC and the industry and should be considered in conjunction with this study.

Also, this review did not fully explore or develop all-encompassing solutions to the problem areas identified. Although a number of suggestions to improve administration are included in the report, it is believed that comprehensive meaningful recommendations cannot be made without a thorough consideration of all facets of the industry. Such recommendations must await the pending industry-wide review to be undertaken by this Committee. However, in the interim, there appears to be no reason why the Commission, which apparently recog-

nizes the validity of the deficiencies discussed in this study, cannot proceed to take corrective action.

The review concentrated on a selected number (46) of broker-dealers who went into some form of liquidation—bankruptcy, receivership, merger, acquisition, revocation of registration during the three year period ending December 31, 1970. The firms selected represented a wide geographical distribution and included all sizes—large and small, exchange members, NASD members, and organizations regulated by the Securities and Exchange Commission only (SECO). The review was limited primarily to an examination of Commission records in its headquarters office and applicable regional offices. However, some information was obtained from the exchanges and NASD.

Consideration was given to the recent legislation creating the Securities Investors Protection Corporation (SIPC). It is recognized that this legislation is designed primarily to protect investors and will not eliminate the problems encountered by broker-dealers nor the factors that cause them. These problems continue to exist.

At this time I would like to express my gratitude for the assistance of Harold Frei and Joseph Moranto, representatives of the U.S. General Accounting Office, during the review and in the preparation of this report.

Respectfully submitted.

William T. Druhan,
Special Consultant.

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BACKGROUND

In the past decade the securities industry experienced a phenomenal growth period—in some aspects, uncomparable to any other industry. The growth has been estimated at approximately 20 percent a year compounded. There was an extraordinary growth in the number of shares listed on exchanges, number of persons owning shares, number of shares traded, and, as might be expected, the realization of unprecedented profits by the broker-dealers. Market volume in 1968 on all exchanges was 187.75 percent higher than in 1963. On the other hand, during this period, as a result of the growth, a myriad of serious problems were generated. Although these problems had their genesis over a number of years, they were triggered by a reduction in trading volume, a decline in stock values, and a general increase in costs. Significantly, many of these problems were not timely recognized in that little or no action was taken. In many aspects the market decline of 1969–70 was just as devastating as the great crash of 1929. Lacking the suddenness of 1929 it was not as quickly recognized but still required a complete change in the industry's operations and thinking.

Many of the problems resulting from the market decline are industry-wide and the present structure of national and regional exchanges, self-regulatory bodies, and government regulation makes it difficult to deal effectively with them. Many of the problems are unresolved and apparently will remain unresolved in the foreseeable future. This is primarily due to the fact that the corrective actions which were taken were of a temporary nature and were not far reaching enough since no central authority controls all aspects of the industry. In this regard, the president of the American Stock Exchange recently stated:

> Clearly, no governing body within the industry has powers to enforce and control a wide range of decisions affecting all markets. This situation is complicated when government and others demand that the industry regulate itself as if there were a central authority, yet insist that competition among self-regulated markets be fostered.
>
> Thus, the self-regulatory machinery does not exist for solving industry-wide problems.

In the past two years many broker-dealers have liquidated, merged, or ceased doing business. These included all different size firms—large, small, medium—NYSE members, AMEX members, NASD members, SECO members—firms doing a general securities business, underwriting, mutual funds, or a combination thereof. The reasons for the demise of these firms have also been varied—operations losses, mismanagement, market decline, back-office difficulties, inoperable and/or overly expensive modernization programs, insufficient initial capitalization, and fraud.

In order for brokerage firms to take advantage of the exceptional growth during the 1960's, facilities were quickly expanded and personnel greatly increased. In addition, many firms embarked on over-due modernization and automation programs. In providing these needs, premium prices were paid for scarce space and personnel with inadequate regard as to efficiency, need or qualifications. Electronic equipment and computers were obtained without proper programming. It was not uncommon to spend growth dollars to overcome inadequacies in expansion plans and general inefficient operations. In order to retain scarce employees, unreasonable proportions of profit were paid in bonuses and other benefits.

Due to the increased volume, inexperienced personnel, and lack of modern equipment or the proper utilization of such equipment, the industry was beset by operational problems. Broker-dealers were unable to consummate an unprecedented number of transactions in an orderly or timely manner. Regulations require that securities should be delivered within five working days after the trade; however, during this period it was not uncommon for securities to be undelivered after 120 days. At December 31, 1968, the value of "fails" was estimated in excess of $4 billion. This problem was belatedly recognized. Corrective actions were taken in the form of closing the NYSE one day a week, and, when this did not accomplish the desired goal, reducing the daily trading hours one and one half hours to four hours. Nevertheless, the amount of fails was reduced primarily by the subsequent decline in market volume (not related to the number of trading hours) and not by correcting operating procedures by brokers. Moreover, it is reported that where trading volume increased in the latter part of 1970, the number of fails increased at least in proportion to the trading volume increase if not more so because the number of available back-office personnel was inadequate due to unbalanced reductions in force when the volume decreased in 1969.

Although the expanded operations created a need for increased capital and such capital was attracted by the obvious prosperity, in many instances there was a reluctance to accept the additional capital in sufficient quantities.

The sizeable market value decline commencing in 1969 resulted in a serious decline in available capital for broker-dealers. Available capital was impaired because a sizeable portion of a broker-dealer's capital was invested in securities. Also, a portion of the firm's capital was in the form of loans subordinated by securities. When the value of these securities declined, coupled with the broker-dealer's general capital impairment, lenders compounded the problem by removing their capital.

During the growth period there was a proliferation of new firms organized primarily for the purpose of taking advantage of the rapid growth only to find out that the greatest gains had already been made and/or not available to new firms.

Although completely contrary to historical experience, the industry as a whole anticipated that market prices and volume (experienced especially between 1962 and 1968) would continue to rise and that high profits would continue indefinitely. Previous predictions for market volume had proven to be very conservative—market volume in 1968 was higher than the previous predicted volume for several years hence. The industry was unprepared for a decline in market volume. If any long-range planning was done it pertained to the necessity for orderly expansion. No plans were made for an orderly constriction of operations. In 1969 when the market declined it was considered a temporary condition. As a consequence broker-dealers were reluctant to form plans to reduce expenses in keeping with a realistic expectation of income. In those instances where broker-dealers were desirous of reducing expenses, they found it difficult because the previous expansion and/or modernization programs included incurring a number of large fixed costs not readily susceptible to contraction.

Concommitant with the market decline in 1969 there was a considerable decrease in the volume of trading. For example, on the NYSE the daily average volume of trading declined from 13 million shares in 1968 to 11.4 million shares in 1969 and less than 11 million shares for the first eight months of 1970.

The culmination of these problems and events was a severe lack of profitability. Most broker-dealers had sizeable losses from their security commission business during 1969. The extent of lack of profitability can be seen by the fact that the average NYSE member firm reported a loss of 2.9 percent from security commission business in 1969 compared to a profit of 9.9 percent in 1968. In 1969 there were only 32 firms with security commission income in excess of $20 million and only 12 of these firms reported a profit (before Federal taxes). By comparison, in 1968 there were 38 firms with security commission income in excess of $20 million and 31 of these firms reported a profit. In 1969, the security commission business for these firms resulted in an average loss of 5.4 percent whereas in 1968 there was an average profit of 7.8 percent. The lack of profitability is more pronounced for the multitude of small broker-dealers. For example, of the 17 non-clearing firms with security commission income of less than $500,000 included in the NYSE income and expense survey for 1969, only 3 firms reported a profit before income taxes and the group average was a loss of 9.5 percent. The profit squeeze has also been felt by the various exchanges.

The results of the lack of profitability are manifold. Numerous broker-dealers were forced to cease doing business or, at best to obtain an infusion of a considerable amount of new capital and/or drastically reduce operating expenses. Also, the exchanges severely curtailed expenses.

At the outset the firms forced to cease doing business were relatively small and their demise was regarded merely as a timely adjustment through the elimination of marginal firms. There was a refusal to recognize that the larger well-known old established firms were also in difficulty. When a number of larger exchange member firms began to be forced into liquidation there was still a reluctance to admit that severe corrective actions and/or outside assistance was necessary. The inevitable admissions came when it could be seen that available trust funds (established by exchanges—primarily NYSE—to protect customers) were about to be exhausted and considerable losses were being incurred by customers of broker-dealers who were not members of an exchange and therefore not protected by the trust funds.

The various exchanges, NYSE in particular, established trust funds for the purpose of protecting public customers from losses incurred because of broker-dealers' liquidation. The trust funds, however, proved inadequate to adequately protect investors. The trust funds were used at the discretion of the governing bodies of the exchanges, therefore, in addition to having an inconsistent application between the various exchanges, there was also apparent inconsistent applications within exchanges. Moreover, trust funds did not afford any protection for the multitude of public customers whose broker-dealer was not a member of an exchange.

The prime concern of this Committee with regard to the securities industry is to protect private investors (customers) against loss from a broker-dealers financial mismanagement or insolvency. The manifestation of this protection is a complex matter. The investor is protected by the rules of the exchanges, NASD and SEC. Nevertheless, these rules do not indemnify a customer in the event he is unable to recover his funds when a broker-dealer goes into liquidation.

A major step in improving this protection was the recent passage of the Securities Investor Protection Act of 1970 (SIPC). This legislation provides for the establishment of a fund from which public customers may recover up to $50,000 of their accounts (limited to $20,000 cash) in the event of the financial insolvency of their broker. The initial fund to be established by SIPC is to be raised by an assessment on each member of SIPC—defined as practically all broker-dealers maintaining customer accounts.

The legislative history for SIPC did not develop an accurate estimate of anticipated losses from broker-dealer liquidations in the foreseeable future. Information is not available as to the current financial position of the broker-dealers. Admittedly, financial questionnaires are submitted to SEC and the exchanges and reviews are made to determine whether broker-dealers are in compliance with net capital requirements. However, despite "early warning systems" and other procedures, the regulating bodies have found that the data received, although accurate at the "as of" date of preparation, may not necessarily reflect the current condition of a firm. The liquidation of most small firms (non-exchange members) has been brought about by the voluntary submission of data to the SEC. Therefore, to a large extent, the number and amount of liquidations to be carried out by SIPC, at least until different control procedures can be devised, is a complete unknown.

The protection provided by SIPC should not be considered as a panacea to the public customer. Within the limitation of $50,000 per customer, it guarantees against a financial loss due to liquidation of the broker-dealer. However, due to the inefficiencies, mismanagement, or general financial difficulties of a broker-dealer the public customer can incur considerable losses which will not be compensated for by the mere delivery of his securities. For example, a customer who is unable to obtain his stock certificate within a reasonable period of time forfeits the privilege of being in a position to trade the security in order to realize a profit or prevent further losses. He also forfeits the privilege of using his security as collateral for another business venture. Consequently, it is important that emphasis be placed by the regulatory bodies in the administration aspects of broker-dealers. Accordingly, the purpose of this review was to determine the effect this legislation will have and whether additional legislation may be desirable.

The major thrust of this report is to indicate anticipated problem areas in administration of SIPC as reflected by the condition of the industry which resulted in a number of firms being liquidated. As a natural follow-on to SIPC this study attempts to find solutions for broker-dealers going into liquidation; that is, SIPC needs the protection of preventing broker-dealers from rapidly using up the fund.

SUMMARY OF FINDINGS

Our review of a number of broker-dealers who went into some form of liquidation during the period from 1968 through 1970 indicated a need for improvement of several aspects of the regulatory functions. These aspects include the examinations given for principals and registered representatives, financial and eligibility requirements, inspections of broker-dealers, the timely detection of financial and operational problems, and administrative and disciplinary actions.

Our review also revealed that there were many reasons for the failures of these firms, ranging from a single factor attributed to the failure of particular broker-dealers to multiple factors attributed to others. Further, these factors were both internal and extenal to the firms. Internal factors included mismanagement and inefficiencies in operating the firm's business, overexpansion of operations, irresponsible actions by principals, and fraud. External factors included a reduced volume of trading in 1969 and most of 1970 and a large decline in prices of many stocks during this period. Moreover, it was apparent that many broker-dealers, and those that went into liquidation in particular, were not prepared for these conditions. The securities industry had practically no long range planning documented by an inability to handle the large volume of business during 1968 and the almost hysterical ad hoc reactions and solutions to the difficulties that subsequently developed.

Despite the increase in trading volume and market value from late 1970 to date, difficulties of broker-dealers are by no means over. A number of firms were still experiencing problems. The recent legislation creating SIPC will not, in itself, eliminate the problems that broker-dealers encounter nor the factors that cause them.

Because of the limitations of our review, we do not consider the problem areas noted as being all-inclusive, nor did we attempt to fully explore or develop all-encompassing solutions. Many other more serious, complex and far-reaching problems embrace all sectors of the securities industry and their solution will require extensive study.

Those aspects identified as problem areas are summarized in the following paragraphs and are described in more detail in subsequent sections of this report.

Need to improve eligibility requirements for becoming a broker-dealer

Our review disclosed a need for the Commission to make the eligibility requirements for entry into the securities industry more restrictive. At the present time anyone can organize a broker-dealer firm and enter the securities industry provided (1) he has not been convicted within the prior 10 years of any violation of laws and rules involving securities, (2) had not been the subject of disciplinary sanctions by the Commission, (3) has the minimum net capital requirement, and (4) the principal officials of the firm pass a relatively simple general securities examination. If these requirements are met the Commission has no basis on which to deny a registration regardless of the individual's age, experience, reputation, or other factors. Other factors include serious criminal acts not related to the securities industry.

We noted that for some broker-dealers who began operations in 1968 and 1969, many principal officers of the firms had no or very limited prior experience in the securities industry and the firms soon failed. The officers' prior experience was in such vocations as a school teacher, cook, insurance salesman, airlines worker, engineer, automobile salesman, and food salesman. In other cases the principal officers had prior experience as registered representatives with other broker-dealers but evidently were not versed in how to maintain and keep current the proper records. In still other cases the principal officers had changed jobs several times over a short period of time and the Commission did not inquire of their former employers as to their performance and reasons for leaving.

In many cases, broker-dealers, in addition to violating the net capital and record-keeping provisions of the rules and regulations, also violated other provisions such as improper hypothecation of customers' securities, improper extensions of credit to customers, distributions and sales of unregistered stocks, and misappropriation of proceeds from underwritings. In some cases these violations can be associated with inexperience and with lack of knowledge of the rules and regulations, and in other cases it was evident they were willful.

We believe the Commission should adopt rules and regulations and/or, if necessary, recommend legislative amendments that would authorize or permit it to require more strict eligibility requirements for becoming a broker-dealer. For example, in addition to the present types of offenses or acts which bar entry into the securities industry, the Commission should add conviction within 10 years of crimes involving theft, fraud, embezzlement, defalcation, or criminal breach of fiduciary duty. In our opinion broker-dealer applicants should be required to demonstrate that they have principals or supervisors who appear to have the experience and knowledge to manage the firms' activities and thus afford improved protection against losses through failures or misdeeds.

Broker-dealer registrations allowed to become effective although principals were involved in alleged violations of the securities laws

Our review disclosed that three firms became registered with the Commission despite the fact that certain principal officers and directors of these firms had allegedly committed serious violations of the rules and regulations of the Commission as principals or employees of other broker-dealer firms prior to these firms' failures.

We recognize the fact that the Commission had no basis to deny the registration of these firms in question under existing standards, because at the time the applications for registration were filed, the principals had not been barred from engaging in the securities business. It is our opinion that the principals of these firms did not meet the ethical standards of conduct to engage in the securities business. It would seem appropriate to question the basis upon which the Commission is proposing to assure protection to customers of the new firms against the same type of unscrupulous activities aid mismanagement that typified previous operations and losses to customers.

Need to improve eligibility examinations for both principals and registered representatives

The examinations of the Commission and the NASD given to principals and registered representatives are relatively simple to pass and require no particular educational background or experience. We believe the examinations have serious shortcomings in that they do not test adequately the abilities or knowledge of applicants for principals on proper methods of supervision of employees, proper methods of internal control, record-keeping, or generally how to run a brokerage firm. The examinations for registered representatives do not test applicants' ability or knowledge as to how well they can manage other peoples' money and give advice on what securities to buy and sell. The investing public in many instances places reliance on principals and registered representatives in the belief they are professional experts. Based on the examinations they take, such reliance may well be misplaced.

We believe the shortcomings of these examinations were directly related to the failures of a number of brokerage firms. The examinations should be improved so as to require a comprehensive knowledge of the securities industry and the related rules and regulations and thereby raise the standards to a quasi-professional level.

Need to strengthen financial requirements of broker-dealers

Our review revealed a need for strengthening the financial requirements of broker-dealers. During 1969 and 1970, approximately 110 broker-dealer firms entered into bankruptcy or some form of liquidation. The number of failures alone is a good indicator of the inadequacy of current standards regarding financial requirements of broker-dealers and demonstrates the need for upgrading these requirements.

The financial stability of broker-dealers can deteriorate very rapidly, particularly in periods of declining market prices and reduced volume of trading. Both of these factors have a considerable effect on commission income which is not necessarily offset by reduced expenses. In many instances the capital position is sufficient to withstand only a very limited period of such conditions. In addition, many firms include firm-owned and/or borrowed stocks as capital. Many times such stock is subject to considerable fluctuations in value and during a declining market, the capital position can be severely impaired.

To become registered with the Commission broker-dealers who intend to maintain customer accounts need only an initial capital investment of $5,000 in assets readily convertible into cash. The member firms carrying accounts for customers need to maintain a minimum net capital of only $50,000. We noted that many firms become registered with and/or maintain the small capitalization which proved to be insufficient to operate a variable concern.

We believe that consideration should be given to the need for increasing the minimum net capital requirements of brokers and dealers, particularly initial capital requirements.

Minimum capital requirements should be established on a scale commensurate with the size of the firms and the nature of the principal types of business they engage in or contemplate rather than as present, be related solely to the amount of liabilities. Broker-dealers range in size from a very small sole proprietorship with one office to very large corporations with offices throughout the United States and in foreign countries. The raising of the minimum net capital requirements to any specific predetermined level will not guarantee the success of a broker-dealer firm, but it would require a more serious commitment on the part of the principals of small firms and also would provide more protection to the SIPC fund for all firms.

It is a desirable goal to set capital requirements so as not to preclude the entry of worthy and serious individuals into the securities business. At the same time net capital requirements and other requirements for entry into the securities business should be sufficient to more adequately assure reasonable operations and adequate service and protection to customers.

The maximum allowable ratio of aggregate indebtedness to net capital is 2000 percent. Thus, a broker-dealer can incur substantial liabilities in the form of amounts due to customers, other broker-dealers and general creditors. Further, the payment of these liabilities can be limited to the assets of the firm through incorporation. We believe that consideration should be given to substantially reducing the ratio of indebtedness to net capital in order to provide more adequate stability of the firms.

Many broker-dealer firms obtain capital through subordination agreements whereby lenders provide cash and/or securities to broker-dealers for specified periods of time. Capital obtained through this means can and has created problems for broker-dealers, particularly those encountering financial difficulties. At the very time troubled firms needed to retain their capital and attempted to raise additional capital, lenders were withdrawing their cash or securities as the subordination agreements expired or upon giving the proper notice to the firms. We believe that consideration should be given to strengthening subordination agreements by increasing the periods of loans and restricting withdrawals when they result in an impairment of net capital.

Under certain conditions, broker-dealers can use their public customers' free credit balances as temporary capital or as collateral for loans from financial institutions for their day-to-day operations. However, the practice of using customers' free credit balances is not always a stable source of capital because these funds are required to be paid back to the customer upon demand. It was proposed during the debate leading to SIPC that broker-dealers be required to physically segregate free credit balances. However, no conclusions were reached in regard to this matter.

In January 1971 the NYSE Board of Governors approved in principle and submitted to the Commission a document designated as the first phase of amendments to its net capital rules. The first phase amendments pertained to increasing the deductions from net capital for firm-owned and/or borrowed stocks, providing further deductions, with certain exceptions, for undue concentrations of stocks of the same issuers, and establishing or increasing net capital deductions for short securities differences and uncollected dividends due a member firm. The fact that these amendments were proposed indicates that the NYSE recognizes that changes are necessary because of the capital problems experienced by member firms in the last several years.

Inconsistencies in determining necessity for and methods of liquidation of broker-dealers

Our review revealed inconsistencies between the various exchanges and within the Commission as to the determination of whether a broker-dealer should be liquidated and in the manner such liquidations are implemented. Obviously much of this problem will be alleviated by SIPC. However, the probem is still worthy of note because in fairness firms should be treated uniformly as to whether liquidation is required.

We noted in our review that the New York Stock Exchange is the sole judge as to whether a financially troubled member firm should be liquidated. When a firm is to be liquidated, the Exchange appoints one of its members to liquidate the firm. The policy of the Midwest Stock Exchange, on the other hand, requires that a court-appointed receiver adjudicate all claims of customers of an insolvent member firm. The Pacific Coast Stock Exchange has acted as a court-appointed receiver to liquidate insolvent member firms.

Our review also revealed that in some cases the NYSE worked as long as two years or more with certain troubled member firms in attempting to help solve its problems. Despite critical bookkeeping and capital problems of certain firms, the Exchange allowed the firms to remain in business because it felt that the severity of these problems and the number of customer accounts involved would not have allowed orderly liquidation had the firms been suspended.

In its oversight of the self-regulatory function we noted that for one firm the Commission followed very closely the actions of the NYSE and the progress being made in attempting to overcome the firm's problems. In other cases, however, the Commission did very little to oversee or monitor the actions being taken by the NYSE in helping firms with problems and, it appeared to us, the Commission was not fully aware of the severity of the problems. In still other cases, the Commission computed net capital ratios of NYSE member firms to be in excess of the maximum legal ratio of 2,000 to 1. However, the NYSE computed the net capital ratios under its interpretation of its rules and determined the firms were not in violation of the maximum allowable ratio. The Commission did not or could not take any actions because it has exempted NYSE member firms from the Commission's net capital rules.

Lack of adequate and timely data at the Commission on the financial condition and results of operations of broker-dealers

Broker-dealers are required to file reports of their financial condition each year. There is no requirement that all firms have to use the same dates for their reports or that individual firms have to file on consistent dates between years. The Commission has supplemented this data with occasional studies and other information concerning the operations of the industry. However, the Commission acknowledged that the reports and supplemental information was received at various times and in various formats, thus preventing meaningful comparisons.

Effective January 1, 1969, the Commission amended its rules to require the periodic reporting of more comprehensive data by broker-dealers. The first reports were to cover calendar year 1969 and are due to be filed with the Commission by April 30 or May 31 after the year covered by the reports. The increased data should be helpful to the Commission and the self-regulatory bodies in performing their regulatory and oversight functions. However, this data is primarily historical in nature. As shown in the schedule attached (Appendix A) and detailed in the case studies. (Appendix B), the financial condition of broker-dealers can deteriorate in a short time. Consequently the value of new reports may be limited.

In addition to the need for more meaningful and timely financial and operating data at the Commission, we believe that broker-dealers should be required to reveal the condition of their business as a matter of public information. The data to be revealed should include the normal balance sheet as well as operational data such as the profit and loss, net capital ratios, the amount of fails both by amount and numbers, by type and completely aged and, most important, any types of restrictions placed upon it by a regulatory body. It appears paradoxical that the Commission should devote a considerable amount of its efforts in determining that investors have sufficient data with which to evaluate securities and to make informed investment decisions and not requiring any information pertaining to the risk of doing business with particular broker-dealers.

It has been argued that the disclosure of the financial condition of a broker-dealer might precipitate a financial crisis due to a lack of investor confidence in the broker-dealer. This argument appears fallacious because there appears to be no reason why the regulatory bodies should protect the broker-dealer at the expense of the public from a condition which should not be permitted to exist.

Need for more timely detection of broker-dealers' financial problems

The Commission and the self-regulatory organizations become aware of broker-dealers having financial difficulties through several means. When financial difficulties are detected, the firms usually are put under some form of surveillance until the difficulties are eliminated or until the firms are forced into liquiduation. However, the financial position of broker-dealers can deteriorate into insolvency or the brink of insolvency very rapidly, sometimes in the matter of a few days or weeks. We noted several instances where by the time the Commission or the self-regulatory organizations became aware of the difficulties it was too late for any corrective actions and the firms had to be liquidated.

It is vital that any financial difficulties be detected at the earliest possible time so that corrective actions can be taken, if feasible, and so that any losses by customers and/or the SIPC fund will be minimized. It was the intent of the legislation creating SIPC to develop and carry out procedures reasonably designed to detect approaching financial difficulties of broker-dealers. Accordingly, when such procedures are being developed, in order to carry out the intent of the legislation the Commission should consider requiring firms to report to their regulating authority and SIPC:

(*a*) when they have operating losses for three consecutive months;

(*b*) the specific names and quantities of securities (firm-owned and borrowed) included in capitalization, and any market fluctuations in such stock in excess of certain predetermined percentages.

Timeliness and adequacy of inspections of broker-dealers

An important tool of surveillance over broker-dealers by the Commission and the self-regulatory organizations is the inspection programs they conduct to determine whether the broker-dealers are in compliance with the Federal securities and the rules and regulations thereunder. Because of the size of the Commission's staff available for inspections in relation to the total number of broker-dealers—the Commission's largest regional office had only 10 inspectors in May 1970 for the 2,000 broker-dealers located in its area—there were times where three years or more elapsed between inspections. We noted that the inspections were not comprehensive but only included a small segment of the overall operations of the firms, such as bookkeeping, analysis of stock transactions, or a computation of net capital. We noted also instances where inspections that were made may have not been adequate even in the limited areas they covered.

It appears that the Commission and the NASD attempt to inspect newly created broker-dealers about 5 or 6 months after the firms commence operations unless they become informed of difficulties at an earlier date. However, several newly created broker-dealers with small initial capitalization encountered financial difficulties at the time they began operations or within a month or two thereafter.

We believe there is a need for more timely inspections of broker-dealers, particularly those which have a prior history of problems and newly organized firms with very small capital. It is evident that the Commission is unequipped to initiate a sufficient number of adequate and thorough inspections each year. Therefore, there should be increased coordination between the Commission and the self-regulatory organizations in scheduling and making inspections. For newly organized firms, we believe an inspection should be made within 30 or 60 days after they start operations. Earlier inspections of some firms that failed might have detected the firms' problems and corrective actions taken before they reached critical proportions.

Adequacy and timeliness of administrative or disciplinary actions by the Commission

Our review disclosed instances where the Commission's administrative or disciplinary actions did not appear to be timely or adequate. In several cases in which the Commission had authorized administrative proceedings or formal investigations to determine the validity of alleged violations of the rules and regulations, cases had remained open for as much as 14 months at June 30, 1970. By the time the Commission eventually got around to suspending certain individuals of one of these firms from association with any broker or dealer, they were no longer in the securities business. In two other cases the Commission ordered brief suspensions of the firm's registrations at a time when these firms were not engaged in a securities business. In another case, after more than 15 months, the Commission had not held hearings on whether a very large member firm of the NYSE should have its registration suspended pursuant to a private administrative proceeding ordered in March 1969.

59-242—71——2

INTRODUCTION

The primary purpose for the securities industry is the capital formation process by which a corporation draws upon the accumulated savings of many investors through the issuance of its corporate securities and the reinvestment of the public proceeds in new plant and equipment. The process can only function, however, if investors have confidence in the basic integrity and stability of the market place. The Securities Act of 1933 was intended to restore investor confidence by public disclosure of all financial and other data bearing upon the worth of securities so that they might be realistically evaluated by investors. It also sought to outlaw fraud in the sale of securities under a broadened concept of fraud not limited by technical common law definitions. Therefore, the Securities Act of 1933 requires registration of issuances of securities before sales of those newly issued securities can commence.

The Securities Exchange Act of 1934 is the single most important statute administered by the SEC. Through its requirements of periodic financial reporting by publicly-held corporations and through its antifraud provisions, the Securities Exchange Act of 1934 constitutes the basis for a substantial body of Federate corporate law which has been developed by the SEC in its administrative decision-making processes and by the Federal courts both as appellate tribunals for SEC decisions and as courts for the judicial determination of the rights of individual parties.

The Securities Exchange Act of 1934 requires registration of:

(*a*) securities listed for trading on a stock exchange;

(*b*) securities for all other companies which have at least 500 shareholders and $1 million in total assets;

(*c*) brokers and dealers who use the facilities of interstate commerce to trade in securities;

(*d*) national securities exchanges; and

(*e*) trade associations of brokers and dealers exercising self-regulatory authority. Only one association—the NASD—is presently so registered.

Corporate reporting requirements

By the enactment of the Securities Exchange Act, the Congress extended the "disclosure" doctrine of investor protection as found in the Securities Act to securities listed and registered for public trading on national securities exchanges. In 1964 the Act was substantially amended to extend the same disclosure and reporting requirements to companies whose securities are traded over-the-counter if they have at least 500 shareholders and $1 million in total assets.

All companies become subject to the reporting requirements by the requirement for filing a registration statement. Through its rule-making powers, the SEC has prescribed the data which must be reported and the standards to which such reports must conform. While the data is generally comparable to the disclosure required under the Securities Act, in many instances it is less extensive. Following the registration of their securities, such companies must file and keep current the following:

1. Annual report showing among other things management control and compensation, outstanding securities, and certified financial statements.
2. Semi-annual report showing, on an unaudited basis, six months revenue and earnings information. (The New York and American Stock Exchanges require similar information on a quarterly basis.)
3. Monthly reports showing any changes in corporate control, acquisitions or mergers or substantial issuances of new securities.
4. Ownership reports showing the equity ownership of officers, directors and substantial stockholders. All changes in equity ownership must be reported by the individual monthly.

The Securities Act and the Securities Exchange Act, although enacted separately to prevent differing abuses, were intended to form one integrated disclosure pattern and subsequent administrative and judicial determinations have expanded on this pattern. Proposals have been made for one statute which would integrate the disclosure and anti-fraud restraints of both Acts. These proposals have been made because each Act requires disclosure of different information and actually all the information should be made available to all investors in one central file for each reporting company. The SEC has been reluctant to urge such reform legislation because of a recognition the passage of a new integrated statute might permit dilution of the stringent provisions of the present laws. In a study conducted under the aegis of then Commissioner Francis Wheat and published for public comment in 1969 it was suggested that the SEC use its regulatory authority to integrate the reporting requirements of both Acts into one file on each company which would be regularly updated with current material information. The necessity of such a central file can be seen when it is noted that under the Securities Exchange Act a company must file an annual report with the Commission which does not describe in any narrative fashion the business of the company but contains financial reports reflecting revenues and income; unless a company is selling its securities to the public, no registration statement is required under the Securities Act but if such a registration statement is filed a company must then describe its business and disclose the relative profitability of each line of business. The Wheat Report recommendations would require a reporting company to describe its business and to disclose product line breakdowns on an annual basis. This regulatory approach to the problem appears preferable to legislation. If anything, SEC should be criticized for failing to implement these procedures many years ago.

Registration of stock exchanges, brokers and dealers and self-regulatory associations

All national securities exchanges must be registered with the SEC. To obtain registration, exchanges must show that they are so organized as to be able to comply with the provisions of the statute and the rules and regulations of the SEC and that their rules contain provisions which are just and adequate to insure fair dealing and to protect investors. While the law contemplates that exchanges shall have full opportunity to establish self-regulatory measures insuring fair dealing and the protection of investors, it empowers the Commission by order, rule or regulation to "alter or supplement" the rules of exchanges with respect to various phases of their activities and trading practices if necessary to accomplish the statutory objectives.

Generally, the larger firms are NYSE members. Moreover, NYSE firms do more exchange and over-the-counter business than member firms of other exchanges or non-exchange firms. Nevertheless, the majority of the registered broker-dealers are small organizations. It was testified in 1963 that about 70 percent of the total NASD membership had less than 10 registered representatives. As of June 30, 1969, about 24 percent of all broker-dealers registered with SEC were sole proprietorships and many of the corporations registered are owned and operated by one person.

As of June 30, 1970, there were 5,224 broker-dealers registered with the Commission. This is an increase of 431 from June 30, 1969 when there were 4,793 firms registered. Most of the registered broker-dealers were members of the National Association of Securities Dealers (NASD). The increase in total broker-dealer registrations by SEC was reflected by NYSE, the other exchanges and NASD in that they all had an increase in membership in 1969. For example, NASD membership increased by 442 and NYSE admitted 24 new member organizations. These figures, however, do not reflect the considerable turmoil that has existed for the past two years.

NASD had 4,348 member firms and the New York Stock Exchange (NYSE) had 622 member organizations at June 30, 1969; however, only 379 of the NYSE members carry customer accounts. The total membership in both NASD and NYSE is less than it was eight years ago.[1] Also the yearly fluctuations are not as severe as in years past. For example, the Special Study of Securities Markets [2] reported that "During the fiscal year ended June 30, 1962, 1,161 new broker-dealers were registered and 793 registrations were terminated, or 21 and 14 percent, respectively, of a registered broker-dealer population of 5,500 at the start of the year." On the other hand, during the fiscal year ended June 30, 1969, 787 new broker-dealers were registered and 391 registrations were terminated, or 16 and 8 percent respectively, of a registered broker-dealer population of 4,793 at the start of the year.

The registration of brokers and dealers engaged in an interstate securities business is an important phase of the regulatory plan of the Act. The mere use of the mails or any other facility of interstate commerce to transact any business is sufficient to establish the jurisdictional nexus requisite for requiring registration. The statute draws a definitional distinction between brokers, who are mere agents effecting transactions for securities accounts of others, and dealers, who trade as principals for their own account. The application of the Act to both brokers and dealers, however, is identical for all intents and purposes.

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[1] NASD total membership was 5,764 as of June 30, 1962.

[2] Report of Special Study of Securities Markets of the Securities and Exchange Commission, 88th Cong., 1st Sess. HD No. 95, Pt. 1.

Both brokers and dealers must conform their business practices to the standards prescribed in the law and the SEC's regulations for protection of investors. These regulations prescribe (1) bookkeeping and other recordkeeping standards, (2) minimum net capital requirements, (3) borrowing on customer securities without the actual authorization of the customer and (4) manipulative trading practices which may result in artificial market prices of securities. Violations of these regulations may result in the possible loss of registration with the SEC or suspension of activities for a period of time.

The Act, however, originally contained no provisions for the registration or regulation of individual members of a brokerage firm and, therefore, disciplinary action against such individuals are not possible. To correct this situation, in 1938 the Congress provided for the creation of self-policing bodies or associations among over-the-counter brokers and dealers. This amendment permits, through an inherent repeal of antitrust restraints against group boycotts, retail price maintenance and otherwise, a voluntary association to establish, maintain and enforce a voluntary code of business ethics. Only one such association, the NASD, is registered with the SEC. Other associations, such as the Put and Call Dealers Association, have been denied such registration because of their failure to establish a public need for registration.

Brokers who are members of the NASD may not deal with nonmember brokers on any terms other than those accorded to public customers. All sales and management personnel of NASD firms must successfully complete an examination to handle public customers and must remain in good standing with the association.

Antifraud Provisions

The antifraud provisions of the Securities Exchange Act have equal applicability to all persons and all securities transactions, regardless of whether or not the registration requirements may be applicable. Of course, the conduct of any business while failing to satisfy any necessary registration requirements constitutes a fraud.

The antifraud provisions of the Securities Act only apply to the *sale* of a security but those of the Securities Exchange Act apply both to the *sale* or *purchase* of securities. Both outright misrepresentations and the withholding or omission of pertinent facts constitute a fraud. For example, it is unlawful in certain situations to purchase securities from another person while withholding material information which would indicate that the securities have a value substantially greater than that at which they are being acquired. These provisions also apply to transactions between management and the corporation if stockholders are not made fully aware of all the details involved in a transaction.

Other types of fraudulent activity include the manipulation of security prices by the stimulation of market activity by rumors or inordinate purchases; by excessive trading in customer accounts (churning); by unsuitable recommendations for security purchases (e.g. switching an 89-year old widow out of a dividend-paying stock into a long-term growth situation); by excessive mark-ups in securities prices; by conducting business while insolvent; and by misappropriation of customers' funds or securities.

Public and private remedies

The Securities Exchange Act authorizes the SEC to institute administrative action against all registered securities exchanges, brokers and dealers, and reporting companies. In 1967, for example, the Commission instituted administrative proceedings which resulted in the revocation of the registration of the *San Francisco Mining Exchange* and, of course, the dissolution of such exchange. Administrative proceedings against brokers and dealers may result in the termination or temporary suspension of their registration and, therefore, their right to conduct business. Administrative proceedings can be instituted against companies to compel correction of inaccurate or incomplete reports, to order changes in accounting treatment and to direct the filing of reports. Administrative orders may be appealed to an appropriate Federal Court of Appeals and violations of orders are punishable by fine or imprisonment.

The SEC is also authorized to institute in its own name injunctive action to compel compliance with its rules and regulations and to restrain further violations of law, rules or regulations. The Commission may seek in appropriate cases, enjoinment of stockholder meetings until proxy material is corrected and it may seek the appointment of a conservator to manage a corporation if present management operates in flagrant disregard for the legal rights of shareholders. As a general rule, injunctive action will lie for any cause for which administrative remedies are also available. The SEC has complete discretion as to which form of remedy on which it will proceed although injunctive actions are preferable when the violations are clear and require immediate cessation.

Any willful violation of any provisions of the Act, or any rule or regulation promulgated thereunder, constitutes a crime punishable by imprisonment for up to two years and/or a fine of up to $10,000.

One important power granted to the SEC, which has seldom if ever been availed of, is the right to sue in Federal court for collection for forfeitures. Failure to file information, documents or reports required by the Act or SEC regulations is subject to a forfeiture to the United States of the sum of $100 for each and every day such failure shall continue. It is believed that more reports are filed late than on time. The essence of a "full disclosure" concept is that information be made available as soon as possible to permit informed trading in securities. Failure to report permits insiders and their associates to take advantage of the market situation to insure themselves against loss or to gain at the public expense. Apparently, to a large degree the Commission has failed to monitor reports, to seek timely filings and to collect forfeitures.

Public investors are given the right under the Act to institute in Federal distirct court actions for damages and/or for injunctive relief. Stockholders may instiute actions to set aside corporate mergers and acquisitions if full disclosure is not made in the proxy soliciting materials. Brokers and dealers may be held pecuniarily liable for any antifraud violations. Brokers are entitled to sue each other and their customers. Awards for damages are limited to actual losses but the courts have encouraged individual litigation through the practice of liberal awards for expenses in bringing suit, particularly attorneys' fees.

SCOPE OF REVIEW

We reviewed the files of the Commission's headquarters office for 46 broker-dealers who went into some form of liquidation-bankruptcy, receivership, merger, acquisition, revocation of registration—during the 3 year period ending December 31, 1970. We also reviewed the files at the Commission's Boston, Chicago, New York, and San Francisco Regional Offices and at the Los Angeles Branch Office for 31 of these broker-dealers. We discussed some cases with officials of the Commission's headquarters office and the regional and branch offices stated above, where appropriate, to attempt to obtain more complete or supplementary information on the cases we reviewed.

The broker-dealers we reviewed included very large firms, medium sized firms, and small firms. Some were members of one or more stock exchanges and/or the NASD and others were neither a member of a stock exchange nor a member of the NASD. The firms were located in various sections of the country except for the southeastern section. It has been stated that 110 broker-dealers went into some form of liquidation during 1969 and 1970. We did not verify this figure or whether there were other failures during this period. We obtained a very limited amount of information from the NYSE, AMEX, certain regional exchanges, and the NASD, relating primarily to some of the more relevant rules and regulations applicable to member organizations and a summary of actions and statistics for the period June 1968 to June 1970 from the NASD of its surveillance over member firms operational and financial condition.

We also obtained some overall data on the securities industry and read provisions of the Federal securities laws and related rules and regulations thereunder which we considered pertinent to our review. However, we did not make an in-depth study of the legislation and the rules and regulations to determine if there was a need for changes therein.

Our review did not include a review of the files and records of the stock exchanges or of the NASD for the 46 broker-dealers. Also, we did not visit or obtain any information from any broker-dealers.

NEED TO IMPROVE ELIGIBILITY REQUIREMENTS FOR BECOMING A BROKER-DEALER

Our review disclosed a need for the Commision to make more restrictive the eligibility requirements for becoming a broker-dealer to purchase, distribute, and sell securities for its own account and/or the account of the investing public. At the present time anyone can organize a broker-dealer firm and transact business with public customers provided (1) he has not been convicted within the prior 10 years of any violation of laws and rules involving securities, (2) had not been the subject of disciplinary sanctions by the Commission, (3) has the minimum net capital requirement ($5,000), and (4) the principal officials of the firm pass a relatively simple general securities examination.[8]

[8] Comments on general securities examination appear on p. 23.

If these requirements are met, the Commission has no basis on which to deny registration and entry into the securities business, regardless of the individual's age, experience, reputation or other factors. Serious criminal acts not related to the securities industry also do not bar entry into the industry. These acts include theft, fraud, embezzlement, defalcation, or criminal breach of fiduciary duty. Conviction of these crimes indicate as much potential danger to the investing public as the offenses relating to securities, and potential problems for the regulatory bodies.

The application form for registration as a broker-dealer was designed to disclose such information as the name under which the business will be conducted; address of principal place of business; type of organization, whether the firm, including any of its employees, meet eligibility requirements; whether the firm is a member of the NASD and an exchange; and the type of business engaged in or to be engaged in. The applicant is required to provide the names of all officers, directors and persons with similar status or functions and any other persons who own shares of any class of equity security of the applicants, and their date of birth, education, and business background. Also, a financial statement of the firm as of a date within 30 days of the filing of the application is required.

The information is reviewed in the headquarters office of the Commission. In addition, the names of the applicant and of the officers and stockholders are checked against more than one million entries stored in a computer located in the headquarters office. If the subjects checked have been named in formal filings with the Commission, have been a party to a proceeding, or have been involved in an investigation, such information, together with pertinent dates, relationships and cross references is available immediately as a printout for use by the Commission. Upon request, the Commission performs similar checks on prospective securities salesmen and others whose names are submitted by the exchanges, the NASD and the State securities commissions. In conjunction with the review at the headquarters office, a form is sent to the regional or branch office serving the area where the applicant's principal place of business is or will be located. The regional office is requested to report whether it has any information on the applicant which would serve as a basis to deny or suspend the effectiveness of the registration. If there is no basis to deny the application, registration becomes effective 30 days after the date the application is filed with the Commission.

We noted that the Commission seldom attempts to verify the information appearing on the applications for registration. In some of the cases we reviewed the principal officers listed in the applications had changed jobs several times over a short period of time.[4] There was no indication in the Commission's files, except in one instance, that the Commission inquired of the officer's former employers as to their performance and reasons for leaving. Also, the files did not indicate that the Commission verified the information on the financial statements submitted with the applications, such as cash shown on deposit in banks or the ownership and amount of securities shown as owned by the firm.

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[4] Universal Securities Corp. case study, Appendix B—45.

We noted that for a number of broker-dealers that began operations in 1968 or 1969, many of the principal officers of the firm had no or very limited prior experience in the securities industry and the firms soon failed.[5] The officers' prior experience was in such vocations as a school teacher, cook, insurance salesman, airlines worker, engineer, automobile salesman, and food salesman. In other cases the principal officers had one or several years' prior experience as registered representatives with other broker-dealers but evidently were not versed in how to maintain and keep current the proper records.[6] Within a short time the firms were enmeshed in record-keeping problems and unable to determine the status of their financial condition. Also frequently these firms were violating various sections of the Federal securities laws and the related rules and regulations such as improper hypothecation of customers' securities, improper extensions of credit to customers, distributions and sales of unregistered stocks, and misappropriation of proceeds from underwritings.[7]

Conclusions

We believe that the Commission should devise more strict criteria for eligibility requirements for becoming a broker-dealer. Raising the standards for broker-dealers should result in improved protection against losses through failures or misdeeds by broker-dealers. For example, in addition to the present types of offenses or acts which bar entry into the securities industry, the Commission should add conviction within 10 years of crimes involving theft, fraud, embezzlement, defalcation, or criminal breach of fiduciary duty. The Commission should adopt rules and regulations in this respect and/or, if necessary, recommend legislative amendments that would authorize or permit the Commission to require more strict requirements.

In our opinion broker-dealer applicants should be required to demonstrate that they have principals or supervisors who appear to have the experience and knowledge to manage the activities the firms propose to engage in and the related record-keeping and other supporting services.

The Commission should make, or have made, more thorough inquiries into applicants to assure satisfaction of requirements and accuracy.

We further believe the Commission should have more assurance that the information contained in the financial statements submitted with applications for registration is complete, accurate and fairly presented. This could be accomplished by requiring the statements to be certified by independent public accountants. The cost to the applicants for certification would not, in our opinion, be excessive.

BROKER-DEALER REGISTRATIONS ALLOWED TO BECOME EFFECTIVE ALTHOUGH PRINCIPALS WERE INVOLVED IN ALLEGED VIOLATIONS OF THE SECURITIES LAWS

Our review of the Commission's registration procedures disclosed that once an application has been submitted to Washington and a

[5] Ellis, Stewart & Co. case study, Appendix B-14; Frank P. Ford Co. case study, appendix B-17; T. C. Horne & Co. case study, Appendix B-25; Sutz & Ross, Inc. case study, Appendix B-43; and Universal Securities Corp. case study, Appendix B-45.

[6] Doorley & Co., Inc. case study, Appendix B-12.

[7] Charter Securities Co., Ltd. case study, Appendix B-9; and Phillips (Lowell) & Co. case study, Appendix B-35.

cursory review made of all forms, then it rests with the Commission to disclose reasons, if any, why the application should be denied. According to the Commission, it verifies the information on the application and conducts a name search of the firm's officers and directors through its computer facilities. If everything appears to be in order and the principals of the firm have not been barred from the industry, then the registration goes into effect 30 days from the date it is received by the Commission.

Our review of a selective number of broker-dealer firms disclosed the registrations for three firms were allowed to become effective by the Commission despite the fact that certain principal officers and directors of these firms had allegedly committed serious violations of the rules and regulations of the Commission as principals or employees of other broker-dealer firms prior to these firms' failures. In our opinion, these cases indicate a gap in the eligibility requirements for engaging in the securities business.

The first of these firms involved Babcock & Co., of Ogden, Utah, a one-time partnership broker-dealer firm who became registered with the Commission on April 5, 1964. In April 1967, Robert J. Stead, was employed by Babcock as a salesman and following his employment the firm's volume increased 60 percent. In March 1968, the Commission commenced public proceedings against the firm, its president and Stead to determine whether the firm and these individuals had violated the Securities Act of 1933 by selling certain unregistered stock and also, the antifraud provisions for failing to disclose an interest in a distribution and in failing to disclose transactions with customers which were in behalf of Stead and not in behalf of the firm.

On September 7, 1968, the Commission allowed the registration of a new firm to become effective, the Mountain States Securities, Inc., in which Mr. Robert J. Stead was designated as president, director, and only large stockholder. On December 24, 1968, a hearing examiner rendered his initial decision on the matter involving Babcock & Co., and recommended that the firm's registration be revoked and its principal officer and Stead be barred from being asociated with a broker-dealer expect that after a six-month period, they could be associated with appropriate showing that they would be adequately supervised.

In the first part of 1969, the Commission granted the petitions of the firm, Babcock, and Stead for review of the initial decision of December 24 of the hearing examiner. It was not until June 19, 1970 that the Commission issued its findings and a formal order that revoked the registration of the firm as a broker and dealer. The firm's president was barred from being associated with any broker and dealer for six months and Stead for three months; however, upon serving the period of their suspension they could become associated with a broker-dealer in a supervised capacity upon an appropriate showing that they will be adequately supervised.

Of particular importance which we believe deserves mentioning is, that, the Commission rejected an offer of settlement by Babcock in September 1969. Stead also attempted to settle with the Commission. The Commission questioned whether the firm and its officers had the necessary qualifications to operate a broker-dealer business. Also, the Commission said the offer of settlement would permit them to remain in a business which they were not qualified to conduct, and thus expose the public to risk it should not be required to run.

Stead being the president, director and only major stockholder of the firm presumably directed the operations of the new firm from September 1968 until June 1970 when he began a three-month Commission-imposed suspension. After the period of his suspension, Stead, if he remained with the firm, would have to be adequately supervised by a subordinate officer.[8]

The second firm involved the Ellis, Stewart & Company, Inc., who became registered with the Commission on April 6, 1968, and filed a voluntary petition in bankruptcy on February 28, 1969. Our review disclosed that the president, Stephen B. Ellis, applied for registration as a broker-dealer on August 8, 1969 to do business as Key Industries in Los Angeles. Ellis had commented in his application that as of the date of his application no action had been taken or implied against him by any of the regulatory agencies. It would appear that the Commission was aware of Ellis' past performance, however under present rules and regulations it could not deny his new registration. Although Commission evidence against Ellis only indicated alleged violations, such should have been sufficient to temporarily withhold registration as a broker-dealer. This fact again became known when the 1970 financial statements for the Key Industries filed with the Commission were found to be fraudulent.[9]

The third firm involved the Pacific Securities Co. The firm's president J. Richard Deal, after filing a petition for voluntary bankruptcy on November 17, 1969, became a stockholder of a new firm, First Cascade Securities, Inc. registered with the Commission on April 11, 1970.

Under the application for registration of Cascade, Deal was not listed as an officer of the new firm. Deal's wife, who was a secretary-director with Pacific Securities Co. also held the same position with Cascade. It was stated in Cascade's registration statement that Deal and his wife jointly owned 20% of the stock of the firm.

Seven days after the registration of Cascade became effective, the Commission completed its investigation of the activities of Pacific and on March 18, 1970, the regional office recommended that the Commission institute administrative proceedings against the firm, its president and one of its employees. On June 2, 1970 these proceedings against the firm were approved.[10]

Conclusion

We recognize the fact that under existing standards, the Commission had no basis to deny the registration of these firms because at the time the applications for registration were filed, the principals had not been barred from engaging in the securities business. It is our opinion that the principals of these firms did not meet the ethical standards of conduct to engage in the securities business. It would seem appropriate to question the basis upon which the Commission had or is proposing to assure protection to customers of the new firms against the same type of unscrupulous activities and mismanagement that typified previous operations and losses to customers.

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[8] Babcock & Co. case study, Appendix B-3.
[9] Ellis, Stewart & Co., Inc. case study, Appendix B-14.
[10] Pacific Securities Co. case study, Appendix B-34.

We believe that the Commission should consider these comments in conjunction with our comments on upgrading eligibility requirements for entering the securities industry.[11]

NEED TO IMPROVE ELIGIBILITY EXAMINATIONS FOR BOTH PRINCIPALS AND REGISTERED REPRESENTATIVES

A written examination must be passed in order to become eligible to be a principal and/or registered representative with a broker-dealer.[12] The examinations are given under the auspices of the Commission and by various exchanges, the NASD and a number of States.

Our review of the examinations of the Commission and the NASD disclosed a need to improve these examinations by including questions which will test a comprehensive knowledge of the securities industry. The examinations are relatively simple. They require no particular educational background or experience and are based on the ability of the applicant to memorize a few words and phrases commonly used in the securities business.[13] The investing public in many instances places reliance on a registered representative with the relief that he is a professional expert. Based on the examinations such faith may well be misplaced. We believe that the examination, properly designed, can be an effective means to prevent unqualified or irresponsible individuals from entering the security industry.

We further believe that the shortcomings of these examinations were directly related to the causes of failures of a number of brokerage firms. Our review showed that many firms' net capital problems resulted from bookkeeping or recordkeeping problems that could have been avoided if the personnel had been knowledgeable of the applicable Commission requirements. For example, in one case where the Commission obtained an injunction to refrain from further operations because of bookkeeping violations, although the principal passed the NASD examination, he admitted that he had no knowledge of the Commission's bookkeeping requirements.[14]

During our review we noticed instances of broker-dealers being involved in the illegal distribution and sale of unregistered stocks which can be associated with inexperience and with lack of knowledge of Commission rules and regulations. It appears they could have been prevented had these individuals been adequately tested as to the rules and regulations governing the buying and selling functions.

The NASD, NYSE, AMEX and Pacific Coast Stock Exchange administer the examinations for eligibility for membership in their respective organizations. On the other hand, the Commission contracts with the NASD for examinations for eligibility as SECO broker-dealers.

The NASD registered representative examination consists of 125 multiple choice questions, while the examination for principals consists of 170 multiple choice and true/false type questions. SECO ex-

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[11] See p. 20 for conclusion on broker-dealer eligibility requirements.
[12] Commission Rule 15b8–1.
[13] Statement made by Director, Division of Trading & Markets in a memorandum dated April 20, 1965.
[14] T. C. Horne Company, Inc. case study, Appendix B–25.

aminees take the current NASD examination for registered representatives less the last 25 questions pertaining to the NASD. SECO principals and registered representatives take the same examination but principals are required to obtain a higher score.

The NASD principals examination contains only two questions pertaining to books and records. The more meaningful of the two questions is:

A member is required to make and to keep certain records. For each of the following, indicate by entering in the parentheses the letter corresponding to the correct answer.

(a) must be kept for a period specified by the SEC.
(b) must be kept during the life of the enterprise.
(c) may or may not be kept—no specific requirement in the SEC or NASD rules.

1. ( ) minute books.
2. ( ) bank statement.
3. ( ) personnel records.
4. ( ) partnership agreement or articles of incorporation.
5. ( ) record of sales of Series E Bonds.
6. ( ) copies of records pertaining to background of registered representatives.
7. ( ) powers of attorney.
8. ( ) account cards or records.

This question merely tests the applicant's cursory knowledge of selective kinds of records that must be maintained and/or the length of their retention but in no way tests the applicant's knowledge of the manner in which they are to be maintained or the purpose of their maintenance. Moreover, the NASD registered representative examination does not contain any question pertaining to record-keeping. Consequently, since SECO principals are only given the NASD registered representative examination (and not the principal examination containing two books and records questions) they are not given any question on their knowledge of books and records.

Many of the questions in the NASD registered representative examination do not require any expertise in the securities industry. For example:

In general, the type of security offering the greatest degree of safety to an investor is the—

1. Common stock.
2. Debenture bond.
3. Secured bond.
4. Preferred stock.

If a corporation selects a twelve-month period ending other than on December 31 as the basis for computing and reporting profits, this period is known as the corporation's—

1. Fiscal year.
2. Financial year.
3. Calendar year.
4. Earnings period.

A bond does *not*—

1. Pay interest.
2. Represent a share in corporate ownership.
3. Fall into the category of securities.
4. Represent a public subscription to the corporation's capital structure.

Also, many of the questions require only a primary school level knowledge of arithmetic. For example:

A 3% bond is quoted at 120. The current yield would be:

1. 2.5 percent.
2. 3.0 percent.
3. 4.0 percent.
4. 30.0 percent.

A "no-load" fund (current price $10.00 per share) charges a redemption fee of ½ of 1%. An investor who redeems 100 shares would receive—

1. $99.50.
2. $950.00.
3. $995.00.
4. $1000.00.

An investor following a dollar cost averaging program invests $60 each month in XYZ common. Over a four-month period he has made purchases when the stock was at 3, 4, 5, and 6. His average cost per share disregarding commissions and taxes was

1. $4.00.
2. $4.21.
3. $4.50.
4. $5.00.

During the period of 1961–1969 NASD issued a new examination about every two years, however, very few changes were made in terms of new or revised questions. In fact, certain questions always appeared on these examinations without change. For example, the principals' examination always had a question concerning the computation of various ratios common to small businesses and corporations. The amounts used in these computations were the same each year.

Currently an applicant must obtain a score of 70 percent to pass the registered representative examination, while in 1961 and 1962 a score of 50 or 60 percent respectively had to be obtained. Overall statistics on the failure rate provided by the Commission disclosed that for the month of September 1970, about 26.3 percent of the examinees failed the registered representative examination,[15] while in 1961 and 1962, 3.5 percent and 13.9 percent of the examinees failed.[16] Although there is a sharp increase in the failure rate of applicants taking the NASD registered representative examination, our review disclosed that the increase was due to the raising of the passing grade in 1962, rather than making the examination more difficult.

Conclusion

The examinations for eligibility as a principal and/or registered representative should be improved so as to require a comprehensive knowledge of the securities industry and related rules and regulations and thereby raise the standards to a quasi-professional level.

There are a number of areas essential to a comprehensive knowledge of the securities industry that are only partially included in these examinations and some that are completely omitted. For example, the examination for principals does not include questions to test the appli-

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[15] The failure rate in September 1970 for principals and registered representatives of SECO firms was about 22.7 percent.

[16] Special Study of the Securities Markets (House Doc. No. 95, Pt. 1; 88th Cong., 1st Sess., p. 169).

cant's knowledge of proper methods of supervision of employees, proper methods of internal control over cash and securities, or generally how to run a firm. Also, the examination does not have any questions to test the applicant's knowledge as to whether he knows how to prevent improper acts by salesmen.

The most prominent areas not covered on registered representative examinations are questions to test the applicant's knowledge as to how well he can manage other people's money and give advice on what securities to buy or sell. For example, the examination should include questions on what actions a registered representative would take before recommending the purchase of a stock where his firm does not have a research department. Other questions should deal with the types of stocks a registered representative would recommend under different investment objectives and the types of information the registered representative would obtain regarding the objectives.

We believe that bookkeeping and its comprehension by broker-dealer principals is a most critical part of a broker-dealer firm, yet, it is one area that is scarcely covered on broker-dealer principals examinations. In our opinion all broker-dealer principals should be thoroughly examined in bookkeeping and record-keeping and that examinations not only include questions concerning the records required to be maintained by broker-dealers, but also how they are to be maintained.

NEED TO STRENGTHEN FINANCIAL REQUIREMENTS OF BROKER-DEALERS

Our review revealed a need for upgrading the financial requirements of broker-dealers. The financial position of broker-dealers can deteriorate very rapidly, particularly in periods of declining market prices and reduced volume of trading. Another factor affecting the financial stability of broker-dealers is the including of firm-owned and/or borrowed stocks as capital. Many times such stock is subject to considerable fluctuations in value.

Over the two year period of 1969—1970 approximately 110 broker-dealer firms entered bankruptcy or some form of liquidation. There are many reasons for the failure of these firms ranging from a single factor attributed to the problems of a particular firm to multiple factors attributed to the problems of other broker-dealers or the industry as a whole. The number of failures alone is a good indicator of the inadequacy of current standards regarding financial requirements of broker-dealers and demonstrates the need for upgrading these requirements. The financial difficulties of many broker-dealers are by no means over. As of late 1970, there were a number of firms still experiencing capital and other problems and it does not appear that adequate industry-wide action is about to be taken in the near future by the Commission or the self-regulatory bodies to obviate these problems.

Initial net capital requirement

Our review of broker-dealers recently involved in liquidation proceedings or adjudged bankrupt, disclosed that many of these firms were relatively newly organized firms and had small initial capitalization ranging from the minimum of $5,000 to as much as $250,000.[17] The small capitalization tended to produce a rapid and a relatively serious deterioration in financial stability during the period of market decline in 1969 and 1970.

To become registered with the Commission, broker-dealers who intend to maintain customer accounts need only an initial capital investment of $5,000 in assets readily convertible into cash. The $5,000 minimum was provided by an amendment to SEC Rule 15(c)(3) on May 26, 1965. Previous to this date no minimum was required.[18] As early as 1942 NASD proposed an amendment to its bylaws to require a minimum net capital of $5,000 for members dealing directly with the securities and funds of the public, and $2,500 for those who settled contracts through a bank or another member without receiving securities or funds of any customers. The Commission disapproved the proposal on the grounds that a requirement for minimum net capital did not constitute an appropriate basis for determination of membership under Section 15A(b)(3) of the Exchange Act.[19] The principal objection was that many worthy individuals without capital might be excluded from the securities business.[20]

The principle of financial responsibility of broker-dealers is spelled out in Section 15(c)(3) of the Exchange Act. The Commission is authorized to prescribe such rules—

> as [may be] necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers.

It was the intent of the legislation to permit free access and unlimited entry into the securities business by anyone against whom the Commission had not previously acted and who had not violated certain provisions of the securities laws. To engage in the business a broker-dealer needed only to observe the formality of registering with the Commission and passing a securities examination of either the Commission, the NASD, an exchange or certain States. Rules of the Commission proscribing fraudulent activities, the types of and formats for books and records to be maintained, and ratio of capital to aggregate indebtedness only apply to broker-dealers after they become registered and engage in a securities business.

Maintenance of net capital by firms in operation

In addition to maintaining the initial minimum net capital requirements discussed above, broker-dealers are also required to comply with another net capital requirement.

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[17] Buckingham Securities, Inc. case study, Appendix B–6; Centurion Securities Inc. case study, Appendix B–8; Charter Securities Co., Ltd. case study, Appendix B–9; Ellis, Stewart & Co. case study, Appendix B–14; Fidler Securities Corp. case study, Appendix B–15; Frank P. Ford case study, Appendix B–17; Gardner Securities Corporation case study, Appendix B–18; Goss, Rehart & Co., Incorporated case study. Appendix B–21; M. L. Graham & Co. case study, Appendix B–22; and Sutz & Ross, Inc. case study, Appendix B–43. In addition to these examples, other examples of firms encountering severe financial difficulties are included in other sections of this report; see particularly the section on "Inconsistencies in determining necessity for and methods of liquidation of broker-dealers" beginning on p. 34 for some of the older established firms which were members of one of more stock exchanges.

[18] L. D. Polycarpo Company case study, Appendix B–37.

[19] Special Study of the Securities Markets (House Doc. No. 95, Pt. 1; 88th Cong. 1st Sess. pp. 86–87).

[20] *Ibid.* p. 90.

The Securities Exchange Act of 1934 provides:

SECTION 8. It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly—

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

The "General Rules and Regulations Under the Securities Act of 1934 as in effect October 16, 1968" do not contain any provisions regarding Section 8(b), but the 2,000 per centum requirement is contained in the regulations.[21]

The Commission's definition of the net capital requirements for brokers and dealers provides that generally, net capital is the liquid net assets of a broker-dealer, including appropriately subordinated debt, reduced by certain percentages of the market value of securities owned or borrowed by the broker-dealer.[22] The Commission's net capital requirements guide for brokers and dealers provides a significant exemption from the rule as follows:

An exemption from the rule is also provided for members in good standing and subject to specific capital requirements of the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington and Pittsburgh Stock Exchanges. The Commission has reviewed the rules, settled practices and applicable regulatory procedures of those securities exchanges and deems them to impose requirements more comprehensive than those of Rule 15c3-1. However, this exemption is not available to a member of any such exchange if he is not subject to the capital requirements of the exchange; and a suspended member of any such exchange would become subject to Rule 15c3-1, and would have to be in compliance therewith, immediately upon such suspension.[23]

Based on this exemption it would, therefore, be assumed that the various exchanges are completely implementing Section 8(b) of the Act. However, this is not the case. NYSE Rule 325 provides that the net capital will be computed in accordance with Section 8(b) "unless a specific temporary exemption is made by the exchange in the case of a particular member or member organization due to unusual circumstances." AMEX Rule 446(a) provides for the same exemption. Neither the NYSE nor AMEX rules define what could constitute a temporary exemption nor what would constitute an unusual circumstance.

In January 1971 the Commission stated that it appeared that the net capital rules of most of the exchanges had been relaxed, at least in the last several years. This appeared to have resulted from a concern on the part of the exchanges with the difficulties which might be encountered in closing a large firm. The Commission believed the respective stringencies of the net capital rules had been reversed and that its rules afforded investors the most protection.

The New York State Exchange requires member firms carrying accounts for customers to maintain a net capital of at least $50,000;[24]

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[21] Exchange Rule 15c3-1(a)(1).
[22] *Ibid.*
[23] SEC Release No. 8024 dated January 18, 1967.
[24] Firms with $50,000 net capital could not have aggregate indebtedness of more than $1,000,000. Many firms have substantially more net capital and aggregate indebtedness.

firms not carrying customers' accounts, must maintain a net capital of only $25,000. Certain of the other exchanges also have their own net capital requirements for member firms. The NASD has the same minimum net capital requirements as the Commission.

Capital through subordination agreements

Many firms obtain capital through subordination agreements whereby lenders provide cash and/or securities. For those broker-dealers subject to the Commission's net capital rules, the agreement must be in writing, duly executed by the broker-dealer and the lender; must effectively subordinate any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future creditors; must be for a term of not less than one year; and contain certain other provisions. Prior to October 1970 the rules of the NYSE provided that subordination agreements entered into by its member firms should ordinarily be for at least one year but could be for a period as short as 90 days and could be terminated on 90 days' notice. In October 1970 NYSE promulgated a set of interim guidelines providing that capital contributions to any member firm shall remain at the risk of the business for at least one year, with at least six months' prior notice to be given the firm and NYSE before any capital is withdrawn. The new measures applied to any new capital arrangements submitted to the NYSE for original approval, amendment, or renewal, and to all existing contractual capital arrangements then in effect at member firms unless those arrangements involved contrary provisions.

Capital obtained through this means can and has created problems for broker-dealers. At the very time troubled firms needed to retain their capital and attempted to raise additional capital, lenders were withdrawing their cash or securities as the subordination agreements expired or upon giving the proper notice to the firms. In other cases firms had only a small amount of excess net capital over the minimum requirements and were faced with large amounts of subordination agreements expiring within a few months in the future. Unless the agreements are renewed or capital is obtained from other sources, the firms became in violation of the net capital requirements. The Commission stated in September 1970 that a very large member firm of the NYSE was in serious financial condition.[25] The firm at that time had $9 million in excess capital, all of which came from a subordinated account owned by its employees' pension trust. The account would terminate in January or February 1971, and the firm was trying to raise capital to provide it with the amount needed to carry its aggregate indebtedness of about $200 million. In another case the Commission stated in January 1971 that a very large member firm of the NYSE was again facing a financial crisis.[26] This firm had excess net capital of $12.7 million at the end of December 1970 and had projected capital withdrawals during the first seven months of 1971 totaling $24.8 million.

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[25] Walston & Co.
[26] F. I. du Pont, Glore Florgan & Co. case study, Appendix B–13.

Use of customers' free credit balances

It is a frequent practice for broker-dealers to use their public customers' free credit balances as temporary capital or as collateral for loans from financial institutions for their day-to-day operations. Such balances arise from customers depositing funds or leaving securities or the proceeds from sales of their securities with broker-dealers.

The Commission requires that a broker-dealer must provide each customer, for whom a free credit balance in the form of funds is carried, a written statement at least every three months of the amount due to the customer and notice in writing that such funds are not segregated and may be used in the operations of the business of such broker or dealer, and that such funds are payable on the demand of the customer.[27]

It was proposed during the debate leading to SIPC that broker-dealers be required to physically segregate free credit balances. It was indicated that this would be considered. In the event the broker-dealer intends to use the free credit balances for his own use, he must first obtain the customers' written consent to the hypothecation of their securities. Also, the amount hypothecated cannot exceed the aggregate indebtedness of all customers in respect to securities carried for their accounts.[28]

The broker-dealers are not required to pay interest on these free credit balances. Therefore, in those instances where interest is not paid there are no benefits to the customer to offset the risk of losing his free credit balances in the event of the broker-dealer's liquidation. We inquired of the Commission if it had an estimate of customers' free credit balances being held by broker-dealers at any point in time in 1970. We were informed that the Commission does not obtain this type of data to make estimates and apparently does not consider such data important or necessary for its purposes. It has been stated that since 1968 there has been a steady decline in the amounts of free credit customer balances.

Exchange members

There appears to be a philosophical difference between the New York Stock Exchange and the Commission as to the interpretation of the net capital rule. The Exchange has taken the position that if a firm in capital violation is required to cease doing business it would have an adverse effect on the industry as a whole and in particular on customers' confidence and therefore exceptions should be granted without informing the public so that the Exchange and the financially troubled member firm can attempt to work a way out of the difficulties. In practice, this has had a varied result. For example, in the case of Hayden, Stone, NYSE permitted it to operate in a precarious financial condition for approximately two years. During certain periods within these two years the firm was in violation of the net capital rule. At the end of that time, although the firm was in compliance with net capital requirements, it was known that operations could not continue. Consequently, the customers' accounts were transferred to two other firms and all that remains is a liquidating function, thus alleviating any potential customer losses.

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[27] Exchange Rule No. 15c3-2.
[28] Exchange Rule No. 8c-1.

On the other hand, in the case of First Devonshire, NYSE permitted a net capital violation to exist for an extended period of time but the result was a receivership without assistance from the NYSE trust fund with apparent sizeable customer losses.[29] In this instance contrasting lawsuits have been filed. For example, a group of customers have taken a class action against the NYSE contending that the NYSE should not have allowed the firm to operate while in capital violation because this increased their losses. This same group of customers filed another suit against NYSE contending that the expulsion of the firm from the NYSE was improper because the rule provides latitude for continuing operation with the hopes of reducing losses. Therefore, it can be seen that the Exchange by granting itself latitude for exemption from Section 8(b) of the Act placed itself in a position where it is damned if it does and damned if it doesn't.

In July 1970, the NYSE revealed a proposed plan which called for major changes in its net capital rule. Under the plan member firms would be divided into four categories, each with a different set of capital requirements. The most stringent requirements would apply to firms carrying customers' accounts. The most stringent requirements would be progressively eased for firms engaged in other operations not involving the carrying of customers' accounts. Minimum net capital for firms carrying customers' accounts would be the largest of the following items: sufficient capital to maintain a one-to-twelve net capital-indebtedness ratio; a sum of money equal to 40 percent of "annual fixed operating expenses," plus any contractual commitments, such as futures contracts, that could come due within six months, or $1 million. There was no indication of the status of this proposal as of January 31, 1971.

In January 1971, the Board of Governors of the NYSE approved in principle and submitted to the Commission, amendments to Rule 325 which were the first phase of amendments being considered by the Exchange. The first phase of amendments pertained to increasing the deductions from net capital for firm-owned and for borrowed stock, providing further deductions, with certain exceptions, for undue concentrations of stocks of the same issuers, and establishing or increasing net capital deductions for short securities differences and uncollected dividends due a member firm.

Deductions from a firm's net worth for securities counted as capital (colloquially referred to as a "haircut"), are made for the purpose of recognizing that securities are not cash and that in the event it is necessary to convert the securities to cash, they may not realize their full current market value. Presently, readily marketable securities generally are subject to a 30 percent haircut from their current value, while non-liquid securities such as restricted stocks take a 100 percent haircut. Calculating the deduction can involve difficult judgment factors as to which are and which are not readily marketable. The erosion of the value of securities included in capital was one of the prime factors for most firms getting into capital difficulties in the past two years. For example, in the case of Hayden, Stone a major factor contributing to its merger with Cogan, Berlind, Weill & Levitt, Inc. was that securities included in capital had a market value of $17.5

[29] Subsequently, at the urging of this Committee, the Exchange reversed its position and agreed to protect the customers.

million ($12.5 million allowed after a "haircut") but rapidly eroded to about $6.7 million for capital purposes.

The haircut proposal of the Exchange called for a 30 percent deduction for stocks listed on the New York and American Stock Exchanges; 40 percent for about 400 over-the-counter securities which the Federal Reserve Board permits to be bought on credit; and 50 percent for all other over-the-counter issues and issues traded exclusively on regional exchanges. In addition, haircuts on proprietary positions will be increased where there is an undue concentration in positions other than current positions. Undue concentration was defined as that portion of the market value of securities of a single issuer considered in computing net capital which is in excess of 15 percent of net capital before subtraction of the standard haircuts on marketable securities. Generally, the provision, with certain exceptions, calls for an additional charge on the undue concentration equivalent of one-half of the normal haircut for the security.

The NYSE also has proposed that short security count differences be subject to a 25 percent capital charge 45 days after discovery and to a 100 percent charge three months after discovery. Dividends receivable, both in cash and securities, would be considered initially as allowable current assets but would be subject to a capital charge of 25 percent 45 calendar days after the posting date and of 100 percent three months after the posting date.

These changes were not implemented by the end of January 1971 but were with the Commission for comment. Nevertheless, it is evident that the NYSE recognizes that changes are necessary because of the experience of its members with capital problems in the past several years.

In September 1970 the NYSE informed the Commission that a new problem for the Exchange was developing as the result of the shrinkage of equity capital generally experienced over the last year and a half. Under Rule 325a of the Exchange, member corporations are required to have at least 20 percent of their net worth attributable to capital stock. (The purpose of the provision was stated to be to ensure that the corporation was not capitalized exclusively by subordinated debt.) In September, quite a few corporations were stated to be in violation of this Rule and others were nearly in violation. The Exchange had been working with various firms on recapitalization plans by which debts would be turned into equity, and the firms which were not making progress in correcting the violation had been served with suspension warnings. It was stated that the Exchange would actually suspend a few firms whose lenders and stockholders would not agree to recapitalization, probably under Article XIV of the Exchange's Constitution, which requires a hearing, rather than under Article XIII which allows summary proceedings.

NASD members and SECO firms (not members of exchanges)

Of the 5,056 broker and dealer firms registered with the Commission as of January 31, 1971, 3,857 are firms that are not members of a stock exchange. These non-member firms are all subject to the net capital rules and regulations of the Commission. A firm may choose to join the National Association of Securities Dealers (NASD) but membership in the NASD is not a legal requirement. Nevertheless, rules of the NASD preclude a member firm from dealing with a non-NASD member firm except on the same terms and conditions as those employed in dealing with the public. These rules make membership essential to engage profitably in almost any underwriting and in most over-the-counter business. Members of the Association are regulated by both the NASD and the Commission.[30]

Of the 46 broker-dealers we reviewed, 30 were never members of a stock exchange. Large withdrawals of capital, large amounts of capital in the form of subordinated debt, and very large amounts of securities owed to customers for which firms could not locate the securities, which contributed to the financial downfall of member firms of stock exchanges, were not significant factors in the downfall of the usually much smaller firms not members of an exchange. Rather, the downfall of these latter firms can be attributed to mismanagement and irresponsible actions of principals. These small firms did not have the financial flexibility or capability to overcome sustained operating losses or to recover, for them, relatively large sudden losses due to thefts of cash and securities, speculative trading for the firm's account, or the refusal of customers to accept delivery of large blocks of securities.

On December 1, 1970, the Commission amended its net capital and reporting rules. The amendment provides that a broker or dealer whose membership in one of the specified exchanges is terminated or suspended or which has entered into an agreement for the sale of its membership in any such exchange, which, when consummated, would terminate such membership, is required to file with the Commission within 48 hours after any such event a verified copy of its trial balance and computations of aggregate indebtedness and net capital.

Conclusion

In our opinion serious consideration should be given to the need for strengthening the minimum net capital requirements of brokers and dealers, particularly those just entering the securities industry. A broker-dealer needs as little as $5,000 in initial capital. The allowable ratio of aggregate indebtedness to net capital of 2000 percent permits a broker-dealer to incur substantial liabilities in the form of amounts due to customers, other broker-dealers and general creditors. In some instances these firms do not have the flexibility or standing in the financial community to readily obtain sufficient additional capital when needed and any restrictions on activities compound the problem. Further, payment of liabilities can be limited to the assets of the firm through incorporation.

It is a desirable goal to set capital requirements so as not to preclude the entry of worthy and serious individuals into the securities business. At the same time net capital requirements and other requirements for entry into the securities business should be sufficient to more adequately assure reasonable operations and adequate service and protection to customers. The initial minimum net capital requirements are considerably less than would be necessary to establish most businesses. It would appear that a more realistic minimum net capital requirement should be established on a scale commensurate with the needs of the type of business contemplated.

We believe that consideration should be given to establishing minimum capital requirements based on the size of the firms and the nature of the principal types of business they engage in. Some firms deal

[30] See the section of this report on timeliness and adequacy of inspections.

mostly in mutual funds shares and seldom handle securities or funds of customers; other firms have thousands of customers and hold extremely large quantities of securities and funds of their customers in safekeeping. Some firms engage extensively in underwriting and market making activities. Broker-dealers range from very small sole proprietorships having only two or three employees and one office to very large corporations having thousands of employees and with a number of offices throughout the United States and in foreign countries. The raising of the minimum net capital requirements to any specific predetermined level will not guarantee the success of a broker-dealer firm, but it would require a more serious commitment on the part of the principals of the firms involved and also would provide more protection to the SIPC fund.

It is also questioned whether or not the net capital ratio of 20 to 1 is adequate to assure the solvency of a broker-dealer. It is especially so in those instances where the broker-dealer maintains an inventory of securities. If a broker-dealer has a net capital ratio of 20 to 1, a market decline of as little as seven and one half percent would result in a net capital violation. It would appear that such market fluctuations are not severe, in the past the market declines have been considerably in excess of seven and a half percent. Therefore, more adequate protection should be provided.

When considering the small fluctuation in market values resulting in a net capital violation it should also be noted that net capital computations are not generally furnished to the exchanges, the Commission, or the NASD in a timely manner. Our review revealed that a number of broker-dealers compute their capital "as of" a date as much as three or four months preceding the submission date. Therefore, a market fluctuation between the "as of" and submission dates could cause a broker-dealer to be in a net capital violation without the Commission being aware of it.

INCONSISTENCIES IN DETERMINING NECESSITY FOR AND METHOD OF LIQUIDATION OF BROKER-DEALERS

Our review revealed inconsistencies between the various exchanges and within the Commission as to the determinations of whether a broker-dealer should be liquidated and in the manner such liguidations are implemented. Obviously, much of this problem will be alleviated by SIPC. However, the problem is still worthy of note because, in fairness, firms should be treated uniformly as to whether liquidation is required.

We noted that the NYSE is the sole judge as to whether a financially troubled member firm should be liquidated. When a firm is to be liquidated, NYSE appoints one of its members to liquidate the firm. The NYSE also makes its special trust fund available, if needed, to protect the firm's customers against losses of their cash or securities being held by the firm.[31] We were informed that the Midwest Stock Ex-

[31] There were three significant exceptions to this practice in 1970 where NYSE refused to make trust funds available ostensibly for technical reasons but more likely because such funds were exhausted. NYSE changed its position after discussions with the Commerce Subcommittee conditioned on the passage of SIPC.

change does not follow a policy of liquidating a financially troubled member firm.[32] Instead, this exchange requires a court-appointed receiver to adjudicate all claims of customers of an insolvent member firm before it decides whether to use its special trust fund to cover customers' losses. In at least two cases a subsidiary of the Pacific Coast Stock Exchange agreed to act as a court-appointed receiver to liquidate insolvent member firms.[33]

Officials of the Commission's New York Regional Office stated that once a firm is placed into liquidation they give very little assistance in the liquidation and do not follow closely the progress and results of the liquidation. On the other hand the Chicago and San Francisco Regional Offices and the Los Angeles Brank Office closely follow the progress and results of the liquidations of insolvent firms in their areas and attend meetings between the firms' creditors and the referee in bankruptcy and/or the receivers.

We reviewed the Commission's files on 8 broker-dealers who were members of the NYSE. One of the firms had to sell most of its assets and branch offices to other broker-dealers and another firm was involved in mergers with two other broker-dealers,[34] one firm resigned from the Exchange and later went into bankruptcy,[35] and five firms had to be placed in liquidation by the NYSE.[36]

As might be expected, there were wide variations in the degree and length of surveillance over troubled firms by the NYSE. This was due in part to the degree of the severity of the troubles; however, the large size of some of the firms also appeared to have played a part in the courses of action and the periods they were undertaken by the NYSE. In some cases the NYSE worked with a troubled firm for two years or more in attempting to help solve its problems. The NYSE was reportedly asked why it allowed a few major member firms to continue in business despite critical paperwork and capital problems.[37] The NYSE defended its approach by asserting the severity of paperwork problems in those firms and the great number of customer accounts involved would not have allowed orderly liquidation had the firms been suspended. The NYSE contended that suspensions could have emptied the firms of clerical staffs at a time of intense competition among brokerage firms for skilled operations employees, and an announcement of suspension of these major firms could have prompted a run by customers on firms which did not have a problem. The NYSE added that under a gradual, "scale-down approach," the firm's business and paperwork backlogs were reduced sharply up to their liquidation.

As to the Commission's oversight of the self-regulatory function of the NYSE, we noted that in one case the Commission followed very closely the actions of the NYSE and the firm and the progress being made in attempting to overcome the firm's problems.[38] In other cases

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[32] Kentucky Company case study—Appendix B-27.

[33] The Pacific Coast Stock Exchange Clearing Corporation was appointed receiver for Goss, Rehart & Co., Incorporated (Appendix B-21) and Sierega & Co., Inc. (Appendix B-40).

[34] Hayden, Stone, Incorporated case study. Appendix B-24; and Francis I. du Pont & Co. case study, Appendix B-13.

[35] Doorley & Co., Inc. case study, Appendix B-12.

[36] Amott, Baker & Co., Inc. case study, Appendix B-1; Baerwald & DeBoer case study, Appendix B-4; McDonnell & Co., Inc. case study, Appendix B-29; Pickard & Company, Inc. case study—Appendix B-36; and Gregory & Sons case study—Appendix B-23.

[37] Wall Street Journal, October 2, 1970 cited Blair & Co., McDonnell & Co., and Dempsey-Tegler & Co.

[38] Hayden, Stone Incorporated case study, Appendix B-24.

the Commission did little to oversee or monitor the actions being taken by the NYSE in helping firms with problems, and, it appears to us, the Commission was not fully aware of the severity of the problems.[39] In still other cases, officials of the Commission computed net capital ratios of firms to be in excess of the maximum legal ratio of 2,000 to 1, which would indicate some action should be taken.[40] However, the NYSE computed the net capital ratios under its interpretation of its rules and determined the firms were not in violation of the maximum allowable ratio. As stated on page 28 of this report, the Commission believes that the exchanges have relaxed their net capital rules since about 1969. The Commission has stated that because of NYSE's special trust fund, the Exchange felt able to adopt a "work-out" approach in a number of cases, whereby the firm was allowed to continue in ostensible compliance with the net capital rule while it attempted to bring its problems under control or until it reduced the size of its operations so that liquidation could be made more easily. The Exchange stated that in the case of three of its member firms,[41] the Exchange found itself facing situations where normal application of rules could have meant possible loss for many thousands of customers and potential chaos in the industry. The Exchange stated that in each case, it allowed continued operation under increased regulation, pending a scaling down of business and reduction of paperwork backlogs until the size of the firms were reduced to the extent that they could present a manageable liquidation.

In regard to McDonnell & Co. and Hayden, Stone, Inc., the Commission believed these firms were in violation of net capital rules from time to time but the NYSE allowed them to continue in business for an extended period of time.

It appeared that the NYSE simply carried the McDonnell & Co. while it was having capital problems. To illustrate this point, the Commission noted in its investigation that McDonnell had not been charging capital for certain short security differences. The Commission informed us that this procedure was the result of a discussion beteen the firm and the NYSE and as a result it was purportedly agreed to that since long differences exceeded shorts, no capital charge was necessary at that time. We were informed by Commission officials that this practice represented one of the many liberal interpretations by the NYSE of its rules.

In the Hayden, Stone case, the Commission's NYRO informed the Chairman of the Commission that the NYSE had decided to remove all retrictions against Hayden, Stone in October 1969 which indicated to the Regional Administrator that the Exchange believed the firm was well within the net capital ratio requirement. The NYRO made an analysis of the firm's 1969 financial report and determined that the net capital ratio of the firm was 2,824 percent. The difference was due to the NYRO disallowing certain non-liquid questionable assets. For example, among those assets disallowed was an item of over $4 million representing tax refunds the firm expected to receive. The New York Regional Administrator felt that this item was not a liquid

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[39] Amott, Baker & Co., Inc. case study, Appendix B–1, and Baerwald & DeBoer case study, Appendix B–4.

[40] Memorandum of May 21, 1970. Differences of opinion between the Commission and the New York Stock Exchange on computing net capital and net capital ratios of broker-dealers, and Francis I. du Pont, Glore Forgan & Co.

[41] Dempsey-Tegler & Co., Inc.; McDonnell & Co., and Blair & Co.

asset because no formal claim had been made by the firm for the refund. He recommended that the exemption of NYSE member firms from the Commission net capital rule be deleted and that everyone, small or large, be required to live up to the same set of standards. Our review disclosed that once the Commission established that a non-exchange firm was in violation of its net capital rules, it normally obtained a court injunction against the firm and sought the appointment of a receiver for the firm's assets.

The position taken by the Regional Administrator has logic when the NYSE's handling of Hayden, Stone is compared to those involving the Kentucky Company, a member of the Midwest Stock Exchange. The latter case concerns a firm with a net capital deficiency which hinged on an insurance claim involving the alleged theft by a firm employee of cash and securities worth $533,000. The firm was told by the Commission, and the Midwest Stock Exchange agreed, that the insurance claim could not be recognized in the computation of net capital and that a substantial net capital deficiency existed with the elimination of the insurance claim. This was one of the primary factors in Kentucky going into receivership a month later.

It appears that the only action available to the Commission against the Exchange in allowing certain of its member firms to conduct business while the Commission believed them to be in violation of the Exchange's net capital rule would be for the Commission to remove these firms from exemption of its net capital rule. Our review disclosed that such removal was considered on one occasion [42] but the Commission took no action which, in our opinion, is a good indication that the Commission prefers not to use this means of authority. Its lack of action on this matter stems from the fact that the removal of a NYSE firm from exempion of its net capital rule would put the firm under the Commission's net capital rule and possibly exempt it from the benefit of the trust fund. Based on prior interpretations of its rule, the Commission would have no alternative but to put the firm temporarily or permanently out of business.

About July 1970 the Exchange apparently began making more information available to the Commission on its member firms by holding briefing sessions with officials of the Commission and permitting the Commission to review its files on individual firms.[43] Developments in January 1971 which indicated that the NYSE is striving for higher standards governing net capital requirements for its member firms. The standards which have been proposed as changes in its net capital rule cover some of the matters which the Commission and the Exchange disagreed on in computing net capital for member firms in the past. These proposals are discussed on pages 31 and 32 of this report.

LACK OF ADEQUATE AND TIMELY DATA AT THE COMMISSION ON THE FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF BROKER-DEALERS

Broker-dealers are required to file reports of financial condition with the Commission as of some date within each calendar year.[44]

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[42] Hayden, Stone, Incorporated case study, Appendix B-24.
[43] Francis I. du Pont, Glore, Forgan & Co.
[44] Exchange Rules 17aX5(a), (d).

There is no requirement that the date be consistent between years. Therefore, almost 2 years could elapse between the filing of consecutive years' reports if, for example, particular broker-dealers chose to file their financial reports as of a date in January one calendar year and as of a date in December in the following year. This variance is justified on the basis that the reports are prepared as a result of surprise audits which can occur anytime during the year.

Such reports are to be filed not more than 45 days after the date of the reports, and extensions of time up to an additional 45 days can be granted. As shown in other sections of this report, the financial condition of broker-dealers can change drastically between the dates of submitting financial reports to the Commission.

In our review of the Commission records for 46 broker-dealers we found in almost all cases there was very little or no information on meaningful operating data. The analysis and interpretation of operating data can reveal considerable significant information, such as whether various activities of a firm are producing profits or losses, ratios of types of and total overhead to income, and comparisons with prior years' income and expense and results of operations. Comparisons of operating data for one firm with data of other firms of similar size and similar types of operations is also another important function which can be performed. NYSE annually publishes (but distributes to the members and not the public) income and expense ratios of member firms grouped by size of income but does not indicate the amount of income and expense or the names of the applicable firms. Ironically, many persons familiar with the industry are reasonably certain as to the names of the applicable firms—in fact the Wall Street Journal published such a list. Nevertheless, the investing public is not aware of the actual condition of his broker-dealer. For example, Goodbody & Co. is shown as having a net loss in 1969 of 8.6 percent as compared say to Shearson, Hammill of 10.6 percent. In 1970 Goodbody & Co. had to be liquiduated whereas Shearson, Hammill supposedly is in sound financial condition.

On February 1, 1968, the Commission released for comment by all interested parties a proposed rule to require broker-dealers to file annually more comprehensive financial data.[45] The stated purpose of the proposed rule was to provide comprehensive financial data on a continuing basis so that up-to-date information would be readily available to the Commission, the national securities exchanges and the NASD in connection with their respective responsibilities. The Commission stated that occasional studies, which had necessarily been limited and which became obsolete quickly, had to be supplemented by a continuing flow of reliable data concerning the operations of and changes in the industry. Such information was not then available to anyone on a continuing basis concerning important segments of the securities industry. The Commission continued that it and the self-regulatory organizations were receiving a substantial amount of information, but this information was received at various times and sometimes was in forms preventing meaningful comparisons.

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[45] Securities Exchange Act Release No. 8242.

On June 28, 1968, the Commission announced that it had considered the comments received on the proposed rule, made certain changes therein, and had adopted the revised rule, Exchange Rule 17a–10.[46] The rule became effective January 1, 1969, and the first reports of the more comprehensive financial data were to cover calendar year 1969. The rule originally required the reports to be filed within 90 days of the close of the year, but was amended on February 9, 1970 to allow 120 days for filing the reports and to allow extensions of time of up to 30 days.[47] The rule provides also that broker-dealers that are members of a national securities exchange or the NASD which maintain records containing the information required by the rule as to each of its members, and which transmits to the Commission a copy of the record as to each such member, pursuant to a plan the procedures and provisions of which have been submitted to and declared effective by the Commission, may file the required information with such exchange or the NASD in lieu of filing it with the Commission. An exchange or the NASD will then transmit copies of such information to the Commission and they may omit the names and addresses of members as to whom such information is transmitted. As of August 11, 1970, the American, Midwest, and Philadelphia-Baltimore-Washington stock exchanges and the NASD had filed plans which the Commission had found acceptable. The exchanges will review and edit the data and submit the edited data to the Commission for their member firms who are not also members of the NASD.

The increased financial information submitted by broker-dealers should be helpful to the Commission and the self-regulatory organizations in performing their regulatory and oversight functions. However, this information is primarily historical in nature and does not have to be filed with the Commission until 4 or 5 months after the end of the year covered by the reports.

The financial resources of broker-dealers can deteriorate drastically within this period. About 10 of the 46 broker-dealers whose files we reviewed at the Commission incurred severe losses and failed during the period from January 1 to April 30, 1970, or before the first reports under the new Commission rule were due to be filed with the Commission.[48] It has been said in the Commission that more broker-dealers have failed since July 1, 1968, than in the entire prior period of the Commission's existence.

Conclusion

Broker-dealers should be required to reveal the condition of their business as a matter of public information. The data to be revealed should include the normal balance sheet as well as operational data such as the profit and loss, capital ratio (both minimum requirements and actual increment), the amount of fails both by amount and num-

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[46] Securities Exchange Release No. 8347.

[47] Securities Exchange Release No. 8812.

[48] Buckingham Securities, Inc. case study, Appendix B–6; Centurion Securities Inc. case study, Appendix B–8; Charter Securities Co., Ltd. case study, Appendix B–9; Fidler Securities Corp. case study, Appendix B–15; Frank P. Ford, Co. case study, Appendix B–17; Goss, Rehart & Co., Incorporated case study, Appendix B–21; Kentucky Company case study, Appendix B–27; V. F. Naddeo & Co., Inc. case study, Appendix B–31; Paul F. Newton & Co. case study, Appendix B–33; and Shoemaker & Co., Inc. case study, Appendix B–39.

bers, by type and completely aged and, most important, any types of restrictions placed upon it by a regulatory body. It appears paradoxical that the Commission should devote a considerable amount of its efforts in determining that investors have sufficient data with which to evaluate securities and to make informed investment decisions and not requiring any information pertaining to the risk of doing business with particular broker-dealers. The public customer may make a proper investment as a result of an analysis of the required information on a security but the investment or a portion thereof is lost by the lack of knowledge of the condition of the broker-dealer. Although the customer's account is protected by SIPC there is still a risk factor in some respects equal to that of the investment itself.

It has been argued that the disclosure of financial condition of a broker-dealer might precipitate a financial crisis due to a lack of investor confidence in the broker-dealer. This argument appears fallacious because there appears to be no reason why the regulatory bodies should protect the broker-dealer at the expense of the public from a condition which should not be permitted to exist.

NEED FOR MORE TIMELY DETECTION OF BROKER-DEALERS' FINANCIAL PROBLEMS

The Commission and the self-regulatory organizations have difficulty promptly detecting firms encountering financial difficulties and seeing that such firms take proper and adequate steps to prevent such difficulties becoming so serious as to require liquidation of the firm because the financial condition of brokerage firms can change drastically and rapidly.[49] For example, in the case of Goodbody & Co. (the fifth largest NYSE member firm), although not included in the scope of this review, it was noted that the net capital ratio deteriorated to more than four times the allowable limit before NYSE became aware of the problem. The NYSE became aware of the problem when informed on October 15, 1970 that the audit as of August 30 revealed an aggregate indebtedness of $193,176,000 and net working capital of $2,294,000—a net capital deficiency of $9.65 million and a capital ratio of 87.8 to 1. The rapidity of the deterioration can be seen by the fact that as of the end of 1969 capital was reported as $63 million as compared to $2.3 million eight months later. Why this capital dropped has been reported other than the fact that operational losses amounted to $15 million.

We noted several instances where brokerage firms were in business for only a few months when they encountered financial problems due to substantial operating losses or other erosion of capital through sharp declines in prices of firm-owned or borrowed securities. By the time the Commission or the self-regulatory organizations became aware of the difficulties it was too late and receivers had to be appointed to liquidate the firms or the firms filed for bankruptcy.[50]

The Commission and the self-regulatory organizations become aware of brokerage firms having financial difficulties through a variety of means. Brokerage firms are required to submit a financial

[49] Sierega & Co., Inc. case study, Appendix B–40, and Cutter & Co. case study, Appendix B–10.

[50] Buckingham Securities Inc. case study, Appendix B–6; Centurion Securities Inc. case study, Appendix B–8; Charter Securities Co., Ltd. case study, Appendix B–9; Fidler Securities Corp. case study, Appendix B–15; Gardner Securities Corporation case study, Appendix B–18; and Goss, Rehart & Co., Incorporated case study, Appendix B–21.

questionnaire once a year, certified by an independent public accountant, to the Commission[51] and to a national stock exchange if they are members thereof. From this data the firms' net capital and ratio of aggregate indebtedness to adjusted net capital are computed to ascertain whether they are in compliance with the rules and regulations of the Commission or the applicable exchange.[52] Firms in or approaching violation of the net capital or capital ratio rules are put under some form of surveillance and usually required to submit said computations more frequently (monthly or even weekly) until their financial difficulties are eliminated or until the firms are forced into liquidation.[53]

Another means of detecting brokerage firms having financial difficulties is through inspections of firms by the staffs of the Commission or the self-regulatory organizations. However, the extent to which this means is used is limited because of the small size of available staffs in relation to the total number of brokerage firms.

Other means of becoming aware of financial difficulties noted in our review of Commission records pertaining to some 43 brokerage firms that went into liquidation, receivership, or bankruptcy were (1) officials of the firms voluntarily notified the Commission or the self-regulatory organizations that they were having financial problems and might even be insolvent, (2) the failure to file the financial questionnaires mentioned previously or requests for lengthy extensions of time in which to file them, (3) complaints from the public or other brokerage firms, and (4) through an investigation by the Commission into possible improper sales of unregistered stocks by a brokerage firm or firms.

All of the above means are both necessary and desirable in the detection of financial difficulties of brokerage firms. However, as shown in the case studies of insolvent firms attached, the financial position of a firm can deteriorate into insolvency or the brink of insolvency very rapidly, sometimes in the matter of a few days or weeks. Therefore, it is vital that any financial difficulties be detected at the earliest possible time so that corrective actions can be taken, if feasible, and so that any losses by customers will be minimized.

Conclusion

It is the intent of SIPC to provide a general upgrading of financial responsibility requirements of broker-dealers. Among other things, SIPC is to consult and cooperate with the self-regulatory organizations in order to develop and carry out procedures reasonably designed to detect approaching financial difficulties of members. Accordingly, when such procedures are being developed, in order to carry out the intent of the legislation the Commission should consider:

(*a*) Requiring firms to report to their regulating authority and SIPC when they have operating losses for three consecutive months;

(*b*) Requiring firms to report to their regulating authority and SIPC when the market value of firm-owned and borrowed securities declines more than some stated percentage; and

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[51] Exchange Act, Rule 17a–5.

[52] Exchange Rules 17a–3(a)(11) require brokers or dealers, with limited exceptions, to prepare at least monthly a trial balance and a computation of aggregate indebtedness and of net capital as of the trial balance date; pursuant to Exchange Rule 15c3–1 or in accordance with the rules of a stock exchange if the members have been exempted by the Commission from Rule 15c3–1.

[53] See related discussion on adequacy of net capital requirements and legality of restrictions vis-a-vis requiring liquidation because of violations, p. 27 thru 37.

(*c*) Requiring firms having certain specified securities or types of securities in their capitalization, particularly low-priced securities in the over-the-counter market, to report such facts to the regulating authority and SIPC where it would be monitored for unusual price or volume fluctuation.

TIMELINESS AND ADEQUACY OF INSPECTIONS OF BROKER-DEALERS

An important tool of surveillance over broker-dealers by the Commission and the self-regulatory organizations is the inspection programs they conduct to determine whether the broker-dealers are in compliance with the Federal securities laws and the rules and regulations thereunder. Because of the size of the Commission's staff available for inspections, in relation to the total number of broker-dealers, there are times when three years or more elapsed between inspections of broker-dealers.[54] In the cases we reviewed, we noted that the inspections were not comprehensive because they only included a small segment of the overall operation of the firms such as bookkeeping, analysis of stock transactions, or a computation of net capital. We also noted instances where other information in the Commission files revealed that even where a limited inspection of a particular broker-dealer was made it may not have been adequate.[55]

We noted that several newly created broker-dealers with small initial capitalization encountered financial difficulties at the time they began operations or within a month or two thereafter.[56] The Commission did not make an inspection of the firms until after it was informed of the difficulties by the NASD, the firms themselves or other parties. When the inspections were made the Commission frequently found violations other than net capital deficiencies.[57] It appears that the Commission or the NASD attempt to inspect newly created broker-dealer firms about 5 or 6 months after they commence operations. In many cases they found the firms enmeshed in record-keeping problems and the firms were unable to determine the status of their financial condition. Earlier inspections might have detected these problems and corrective action taken before they reached critical proportions and led to the downfall of the firms.

During fiscal years 1969 and 1970 the Commission made 732 and 707 inspections, respectively. The Commission found 385 and 560 infractions or violations of the rules and regulations for the two years. A total of 68 of these inspections in the 2-year period were of broker-dealers who were not subject to the rules of one of the self-regulatory organizations.[58] We were informed in May 1970 that the Commission's New York Regional Office, the Commission's largest regional office by

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[54] James Anthony & Co., Inc. case study, Appendix B–2; First Securities Co. of Chicago case study, Appendix B–16; Kentucky Company case study, Appendix B–27, and Henry J. Richter & Co. case study, Appendix B–38.

[55] Doorley & Co., Inc. case study. Appendix BX12; T. C. Horne & Co. case study. Appendix B–25; and McDonnell & Co., Inc. case study, Appendix B–29.

[56] Phillips (Lowell) & Co., Inc. case study, Appendix B–35; and Sutz & Ross, Inc. case study, Appendix B–43.

[57] Frank P. Ford Co. case study. Appendix BX17; M. L. Graham & Co. case study, Appendix B–22; Sutz & Ross, Inc. case study, Appendix B–43; and Universal Securities Corp. case study, Appendix B–45.

[58] On the average, about 400–500 broker-dealers are not members of the NASD or of a national securities exchange and thus are not subject to one of the self-regulatory organizations. These firms, commonly referred to as SECO firms, are subject to regulation directly by the Commission.

far, had only 10 inspectors for the 2,000 broker-dealers located in the area served by that office. In addition to making inspections, the inspectors also review and analyze annual financial reports filed with the Regional Office by about 1,700 of the broker-dealers that are not members of a national securities exchange.

During calendar years 1968 and 1969 the NASD made 2,551 and 2,903 inspections, respectively, of its member firms. It filed disciplinary complaints against 80 firms and 82 individuals associated with firms in 1968, and against 123 firms and 69 individuals in 1969.

Conclusion

We believe there is a need for more timely inspections of broker-dealers, particularly those which have a prior history of problems and newly organized firms with very small capital. In view of the number of inspections made annually by the Commission in relation to the total number of broker-dealers, it is evident that it is unequipped to initiate a sufficient number of adequate and thorough inspections each year by its staff. Therefore, there should be increased coordination between the Commission and the self-regulatory organizations in scheduling and making inspections. For newly organized firms, we believe an inspection should be made within 30 or 60 days after they start operations. Such inspections could be limited in scope to a check of the condition of the books and records, computations of the firm's net capital and general observations. New firms would probably not have many transactions in the first month or two; therefore the inspections should be able to be made in a brief time.

ADEQUACY AND TIMELINESS OF ADMINISTRATIVE OR DISCIPLINARY ACTIONS BY THE COMMISSION

In several cases we reviewed broker-dealers had violated various sections of the Federal securities laws and the related rules and regulations of the Commission, and the subsequent actions taken against the firms by the Commission did not appear to be adequate or timely. In eighteen cases we reviewed the Commission had detected violations prior to December 31, 1969 and had authorized administrative proceedings or formal investigations to determine whether the alleged violations were true and what, if any, remedial action was appropriate in the public interest; four of these cases had remained open for 13½ and 14 months, and three cases had remained open for 8 months at June 30, 1970.

In another case, McDonnell & Co., Inc., a member of the New York Stock Exchange and several other exchanges, the Commission's New York Regional Office made an investigation in 1969 into possible improper sales of two stocks at two offices of McDonnell. Also, in 1969 the Commission's Washington Regional Office made an investigation into McDonnell's Washington, D.C. office and certain employees to ascertain whether they had induced customers to engage in securities transactions which were excessive in size and frequency, had established margin accounts and effected transactions for customers without authorization, and had violated the margin rules of the Federal Reserve Board. In November and December 1969 the Regional Offices recommended that the Commission institute public proceedings against the firm and certain of its employees. The Commission did not act on these recommendations until April 9, 1970 when it accepted offers of settlement from the firm and the firm's chairman of the board of directors and former president.[59] The Commission revoked the registration of McDonnell and permanently barred its principal officer from assuming any managerial or supervisory position with any broker-dealer without prior approval of the Commission.

However, this action did not affect other McDonnell employees, fourteen in number, involved in the alleged violations. On April 13, 1970, the Commission announced it had ordered administrative proceedings against the fourteen individuals.[60] The Commission stated a hearing would be scheduled by further order to take evidence upon the staff's allegations against the individuals, to afford the individuals an opportunity to offer any defenses thereto, to determine whether the staff's allegations were true and, if so, whether any action of a remedial nature should be ordered against them by the Commission. On October 20, 1970, the Commission issued its finding and order imposing remedial sanctions for seven of the individuals.[61] The findings and order stated that offers of settlement had been submitted by the seven individuals. Under terms of the offers, the individuals waived a hearing and post hearing procedures and variously consented to certain findings of willful violations and failure reasonably to supervise, and to the entry of an order imposing sanctions. One individual was censured and the other six received suspensions from association with any broker or dealer for periods of 15 business days, 3 months (two individuals), 90 business days, 5 months, and 6 months. The Commission reported that it was stated that four of the individuals receiving suspensions of 3 months, 90 business days, 5 months, and 6 months were not then engaged in the securities business. Considering that NYSE appointed a liquidator for the firm seven months previously (March 1970), it is not apparent what the suspensions of these latter four individuals was intended to accomplish other than establish a record in the event they sought employment with industry sometime in the future. Nor is it understandable why it took almost one year from the time the New York Regional Office recommended that public proceedings be instituted to the time the Commission issued its findings and order. In addition, as of March 29, 1971, the Commission still had not acted on the recommendation of the Washington Regional Office. Such delays are most unreasonable.

In two cases the Commission ordered brief suspensions of the firm's registrations when the firms were not engaged in business.[62] In case one, Snyker, Pearsen, Brown & Co., Inc., the State of Minnesota refused to renew the firm's license on January 30, 1970 because the firm had violated a net capital restriction. On March 13, 1970, the Commission accepted an offer of settlement which, among other things, provided for a 15 day suspension of the firm's registration. The suspension period began on March 23, 1970, during a time when the firm did not have a license to operate in Minnesota.

[59] Securities Exchange Act Release No. 8863; McDonnell & Co., Inc. case study, Appendix B-29.
[60] Securities Exchange Act Release No. 8862.
[61] Securities Exchange Act Release No. 9001.
[62] Sierega & Co., Inc. case study, Appendix B-40; and Snyker, Pearsen, Brown & Co., Inc., Appendix B-41.

In the other case, Sierega & Company, Inc., the firm became insolvent and a receiver was appointed to liquidate the firm on May 28, 1970. On October 23, 1970, the Commission accepted an offer of settlement submitted by the receiver on behalf of Sierega in connection with the offer, sale and delivery of an unregistered stock by Sierega during the period May to July 1968.[63] The Commission suspended the firm's registration for a period of 30 days beginning on October 26, 1970. The Commission stated that Sierega could liquidate existing long (securities) positions and cover existing short (securities) positions without charging commissions on such transactions, and could otherwise continue with the orderly liquidation of the firm during the suspension.

Other cases where the Commission's actions were not adequate or timely are described in Appendix B.[64]

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[63] Securities Exchange Act Release No. 9009.

[64] Dempster Investment Co. case study, Appendix B-11; Francis I. du Pont & Co. case study, Appendix B-13; Houston Securities Corp. case study, Appendix B-26; and Shoemaker & Co., Inc. case study, Appendix B-39.

APPENDIX A

SCHEDULE OF INITIAL CAPITALIZATION AND MONTHS IN BUSINESS FOR SELECTED LIQUIDATED BROKER-DEALERS

Broker-dealer	Initial capitalization	Number of months in business [1]	Date registered with SEC	Date receiver or liquidator appointed
Buckingham Securities, New York, N.Y.	$5,000	9	May 23, 1969	Feb. 20, 1970
Centurion Securities, Inc., New York, N.Y.	7,011	8½	July 1, 1969	Mar. 12, 1970
Charter Securities Co., Ltd., New York, N.Y.	5,000	21	June 30, 1968	Apr. 15, 1970
Doorley & Co., Inc., Providence, R.I.	25,000	27	Dec. 12, 1966	Mar. 14, 1969
Ellis, Stewart & Co., Inc., Los Angeles, Calif.	13,000	11	Apr. 6, 1968	[2] May 12, 1969
Fidler Securities Corp., Beverly Hills, Calif.	250,000	7	Nov. 27, 1969	June 29, 1970
Frank D. Ford Co., Spokane, Wash.	85,765	5	May 14, 1969	Apr. 2, 1970
Gardner Securities Corp., New York, N.Y.	50,000	9	Mar. 12, 1969	Dec. 9, 1969
Goodrich Investment Corp., Beverly Hills, Calif.	15,000	8	Dec. 28, 1967	Oct. 26, 1968
Goss, Rehart & Co., Inc., Los Angeles, Calif.	200,000	16	Jan. 22, 1969	June 12, 1970
M. L. Graham & Co., San Francisco, Calif.	5,000	5½	Oct. 20, 1968	Apr. 1, 1969
Pacific Securities Co., Salem, Oreg.	86,093	19	Apr. 10, 1968	Nov. 17, 1969
Phillips (Lowell) & Co., Dallas, Tex.	[3] 150,144	6	Dec. 4, 1968	June 2, 1969
L. D. Polycarpo & Co., South Dartmouth, Mass.	5,269	74	Oct. 28, 1962	Dec. 13, 1968
Snyker, Pearson, Brown & Co., Inc., St. Louis Park, Minn.	25,000	7½	Mar. 1, 1968	[4] Mar. 24, 1969
Sutz & Ross, Inc., North Valley Stream, N.Y.	55,000	7	May 14, 1969	Dec. 23, 1969

[1] In many cases the broker-dealers ceased doing business, except liquidating transactions, a couple of weeks or more before a receiver was appointed.
[2] Prior to date shown.
[3] Includes $130,000 cash under 14-month subordination agreement in a restricted bank account.
[4] Date of preliminary injunction, receiver not appointed.

APPENDIX B—CASE STUDIES

1. Amott, Baker & Co., Inc.
2. James Anthony & Co., Inc.
3. Babcock & Co.
4. Baerwald & DeBoer.
5. Barraco & Co.
6. Buckingham Securities Inc.
7. W. R. Cavett & Co.
8. Centurion Securities Inc.
9. Charter Securities Co., Ltd.
10. Cutter & Co.
11. Dempster Investment Co.
12. Doorley & Co., Inc.
13. Francis I. duPont & Co.
14. Ellis, Stewart & Co.
15. Fidler Securities Corp.
16. First Securities Co. of Chicago.
17. Frank P. Ford, Co.
18. Gardner Securities Corp.
19. Gemma Securities, Inc.
20. Goodrich Investment Corp.
21. Goss, Rehart & Co., Inc.
22. M. L. Graham & Co.
23. Gregory & Sons.
24. Hayden Stone, Inc.
25. T. C. Horne & Co.
26. Houston Securities Corp.
27. Kentucky Co.
28. Lowell & Co.
29. McDonnell & Co., Inc.
30. Midwestern Securities Corp.
31. V. F. Naddeo & Co., Inc.
32. Naftalin & Co., Inc.
33. Paul F. Newton & Co.
34. Pacific Securities Co.
35. Phillips (Lowell) & Co., Inc.
36. Pickard & Co., Inc.
37. L. D. Polycarpo Co.
38. Henry J. Richter & Co.
39. Shoemaker & Co., Inc.
40. Sierega & Co., Inc.
41. Snyker, Pearsen, Brown & Co., Inc.
42. Sudler & Co.
43. Sutz & Ross, Inc.
44. Union Western Securities, Inc.
45. Universal Securities Corp.
46. World Securities Corp.

Appendix B-1

AMOTT, BAKER & CO., INC.

Amott, Baker & Co., Inc. became registered with the Commission as a broker-dealer on January 1, 1936. Amott, Baker's principal office was located in New York City and it had six branch offices in Connecticut, New Jersey and Philadelphia, Pennsylvania. It was a member of the New York American, and National stock exchanges and the National Association of Securities Dealers. The firm had about 7,000 customers with either open security positions or money balances as of December 31, 1968. About 75 percent of the firm's transactions were stated to be in listed securities and the remaining 25 percent were in over-the-counter securities.

There was no indication in the files that Amott, Baker was having any financial or operational problems prior to November 1, 1968. On that date the firm converted from a manual bookkeeping system to an electronic data processing system serviced by a computer service bureau. Amott, Baker did not retain the manual system as a parallel system during a test period. Therefore, when the new computer system failed to function properly, all control over the books and records was lost.

Apparently the operational problems were first detected by the NYSE, in January 1969. The Commission became aware of the problems in March, 1969. Because of the condition of the books and records, the accounting firm could not complete the audit of the records as of December 27, 1968, and prepare the annual financial report within the required 45 days. On March 14, 1969, it made an inspection of the firm to see if the firm had violated the record-keeping rules.

On March 18, 1969, the Exchange interviewed the officials of Amott, Baker on its back office problems. The Exchange noted certain operating restrictions the firm had voluntarily imposed on itself. The Exchange imposed an additional restriction that no new customers' assets would be permitted to be received by the firm. These actions were apparently not sufficient to satisfy the Commission because on March 26, 1969, the Regional Office held a conference with representatives of Amott, Baker, its public accountants, and its legal counsel and requested that it be advised by March 27 as to what restrictions the firm felt should be instituted in order to obtain the maximum protection for both the firm's customers and other broker-dealers with whom the firm had open commitments. The files do not document the firm's responses. Nonetheless, it appears that it was not satisfactory because on April 3, 1969, the New York Regional Office recommended immediate administrative proceedings against the firm, including suspension of its registration until such time as its books and records problems were alleviated. The Commission approved this recommendation on April 28.

On May 22, 1969, the Regional Office held another conference with Amott, Baker to discuss a pending administrative proceeding against the firm and the severe operational difficulties the firm had encountered. Amott, Baker agreed to furnish the Regional Office (1) a list of all voluntary restrictions which the firm had placed on itself, (2) a brief statement on the firm's capital status and anniversary dates of subordinated loans, and (3) a report on the first four days of the reconstruction of its records. Significantly, no reference was made to the progress being made in raising additional capital. The firm advised the Exchange on April 17 that it was in process of raising additional capital but there was no further information on this subject.

Amott, Baker submitted an offer of settlement seeking to avoid the need of having a suspension hearing. The Regional Office and the Division of Trading and Markets recommended that the Commission accept the offer of settlement. However, the recommendation was subsequently withdrawn when the extent of the difficulties became known.

On September 26, 1969, the Regional Office held another meeting with representatives of Amott, Baker to discuss what progress had been made in solving the firm's back office problems. There was no indication of any disciplinary or other actions taken by the Regional Office.

The NYSE appointed a liquidator for the firm on October 13, 1969. As of January 4, 1971, $1.87 million of the NYSE's special trust fund was made available for the liquidation of the firm. The basis for the Exchange's decision to liquidate the firm was not contained in the files.

The Commission files do not contain sufficient data to make a judgment as to the adequacy and timeliness of the actions. It may be that due to the condition of the books and records of Amott, Baker after November 1, 1968, an accurate or precise financial picture could not be determined. It did not take any disciplinary or corrective actions, other than to order an administrative proceeding against the firm on April 28, 1969. This proceeding had not started as of April 28, 1970. A Commission official informed us that the proceeding probably will not start until the liquidation of Amott, Baker was completed or substantially completed.

Appendix B–2

JAMES ANTHONY & CO., INC.

James Anthony & Co., Inc. of New York, New York, became registered with the Commission as a broker-dealer on November 4, 1953 (originally known as James Anthony Securities Corporation). Although incorporated, the same individual was president, treasurer, and owned 100 percent of the issued and outstanding stock. Anthony was a member of the National Association of Securities Dealers and the National Security Traders Association but was not a member of an exchange.

In February 1968 the Commission became aware that Anthony was a co-defendant in a civil suit in which the plaintiff demanded over $320,000 and was also the subject of Internal Revenue assessments totaling over $1 million. At that time it was questioned whether these claims should be reported as liabilities in computing the net capital position. It was obvious that if these amounts were deducted from net capital there would be a deficiency.

Although the files do not indicate the disposition of these matters, shortly thereafter in April 1968 the Commission received the certified financial questionnaire as of November 30, 1967, which indicated that Anthony was having additional difficulties. This questionnaire indicated that the internal controls were inadequate due primarily to a failure to maintain stock records and detailed control of fails to deliver, fails to receive and firm trading accounts on a current basis. These conditions arose because of an insufficient number of competent and experienced personnel. Obviously these deficiencies constituted violations of the bookkeeping rules. Nevertheless, the Commission did not attempt to ascertain the seriousness of the matter by initiating an investigation or otherwise take corrective action.

When Anthony requested an extension of time for filing its financial report for 1968 the Commission denied the request. This denial was based on the adverse information discussed above plus the fact that a number of complaints had been received from individuals. The Commission had granted such requests for extensions for filing the report in 1965, 1966, and 1967. The 1968 report was never filed. Again, despite the adverse information and the failure to receive a financial report, the Commission failed to initiate an investigaton of the firm.

On January 28, 1969, NASD reported that Anthony agreed to cease its trading until it got its fails position in better balance. It is not clear whether Anthony violated this agreement or actually attained a better fails balance. In any case, Anthony was doing business by February 20 as evidenced by the fact that on this date an Anthony check for about $391,000 was returned to an NYSE member firm because of insufficient funds.

The Commission now commenced an investigation.[1] The investigation revealed that there were numerous other instances where customers' checks were returned because of insufficient funds. Further, it revealed that the books and records were found to be in complete disarray and it was impossible at the time to determine the firm's net capital. Most of the records had not been posted to date; a number of subsidiary accounts failed to agree with the control figures in the general ledgers; Anthony could not determine the amount of cash and securities owing both to public customers and broker-dealers, or vice versa.

On February 28, 1969, based on the Commission complaint, the U.S. District Court approved a consent judgment of permanent injunction and appointed a receiver. The complaint alleged violation of the bookkeeping provisions and a violation of rule 10b-5 in representing to the public that is was ready and able to promptly effect transactions when in fact the firm did not know its financial condition, could not compute its net capital and its books and records were in a chaotic condition.

It is estimated that the liquidation will result in losses to other broker-dealers of approximately $750,000 and to custmers of $35,000. These losses are large considering that Anthony was a relatively small firm (essentially an OTC trading house with only 150 public customers with securities on deposit and/or cash balances). It would appear that these losses would not have been as large had the Commission taken more timely action. When it became known in April 1968 that bookkeeping rules were being violated, the Commission should have taken action immediately rather than waiting ten months until the firm was unable to meet its obligations.

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[1] The only previous inspections of Anthony were on January 9, 1961, March 17, 1961, and October 26, 1966. These inspections revealed that the firm had violated the bookkeeping and certain other rules of the Commission.

Appendix B–3

BABCOCK & CO.

Babcock & Co., a one-time partnership broker-dealer firm with offices in Ogden, and Salt Lake City, Utah, became registered with the Commission on April 5, 1964. Louis W. Babcock was the general manager and partner, and his wife Melba R., was also a partner. The firm conducted a general over-the-counter securities business primarily in local speculative mining and oil stocks. The firm was a member of the National Association of Securities Dealers and the Salt Lake Stock Exchange. Louis W. Babcock stated he had 10 months' previous experience as a salesman for a brokerage firm.

The Commission stated that although its staff warned the firm and its principal officer in 1965 and 1966 of record-keeping deficiencies and that the firm was unable to maintain records on a current basis, Babcock opened a branch office in Salt Lake City and in April 1967 employed Robert J. Stead at that office to increase business volume. Following Stead's employment Babcock's volume increased 60 percent.

Stead stated to members of the Denver Regional Office (DRO) that he joined the firm in April 1967 after Babcock informed him he would be made a partner. He, thereafter, was persuaded by Babcock to wait for the partnership to become a corporation before he acquired an equity interest. In addition to acting as trader for the firm's trading account, Stead also conducted an over-the-counter market by trading in his personal account in many stocks which were also traded by the firm. In a number of other speculative mining securities, Stead was an active market maker by trading through his "customers" account with the firm. On these transactions, the firm retained a full commission, less a 75 percent return as salesman's commission. Stead received no salary. His personal trading amounted to approximately 60 percent of the total volume of the firm's over-the-counter and Exchange business.

When an inspection of the firm was conducted by the DRO on September 27, 1967, the condition of the books and records were such that it was impossible to compute its net capital position. The firm was four days behind in posting ledger accounts and the daily blotter. The security position record had not been posted for five months, and the general ledger had not been posted since June 1. In addition, no record was maintained as to commissions payable to sales personnel, and the firm and Babcock could not estimate what was due salesmen for commissions earned. No computation of the firm's net capital had been made since May 31, and no monthly proof of money balances had been made and preserved.

The firm terminated trading activities on October 6, in order to bring its books and records into compliance with the rules. On December 28, the firm filed a financial report with the DRO and recommenced its securities business the next day. This report followed a three-month attempt to set straight a great number of bookkeeping errors, make adjusting entries in the firm's general ledger, and to determine the liability owed to salesmen for trading commissions.

The Commission reported that Regulation T violations between April 1967 and January 1968 had been numerous and were particularly flagrant in Stead's account due to Babcock's failure to post to the account securities initially delivered into his account by Stead. Babcock informed the Commission inspectors that he had not posted the securities as received into the account since he did not want the auditor to be aware of the speculative nature of the securities in the account.

DRO reported that the firm, Babcock, and Stead caused false and misleading reports of financial condition to be filed under Rule 17a-5 by having Stead take no exception to a questionnaire from the auditor who was preparing the Form X-17A-5 report as of May 31, 1967. Stead had told Babcock that the account, as presented, was incorrect in amount, contained numerous errors, and was faulty in many other respects. The Form X-17A-5 report, as filed, was therefore in error in answer to question 12 by indicating commissions payable of $3,023.71; when in fact the commissions due the employee were substantially in excess of that amount. The money balance of amounts owed customers was also incorrectly stated in the report. The accountant was also misled to report his opinion that the inspection had included an examination of the system of internal control and procedures for safeguarding securities; when in fact Babcock had failed to inform the auditor of securities held for Stead's account, which were not indicated in the books and records of the firm, and were not tagged and secured with other customers' securities. Such securities were found by the DRO staff. The Commission later upon review found there was insufficient evidence to support the charge of reporting violations as they applied to Stead.

The Commission reported that Babcock and Stead jointly acquired an option for 50,000 shares of Triumph Corporation stock from the president of the corporation. (Triumph Corporation is a small exploratory oil and gas corporation in Utah). This option was granted to induce Babcock and Stead to make a market for the shares of Triumph Corporation. The firm, through an account designated R & E Investment sold 89,000 shares of Triumph Corporation stock from April 20 through May 15, 1967, netting $16,012.50 from the sales. This stock was provided by the issuer on sale orders given by the president of Triumph Corporation, and the proceeds from the sale were used by the issuer for operating expenses.

The firm also sold 125,000 shares of the stock of the Silver Shield Corporation from August 21 to September 4, 1967. No registration statement had been filed or was in effect for the common stock of either corporation.

The Commission stated that the firm appeared to be in violation of Rule 15c3-1 in that it operated with insufficient net capital. The Commission stated that it appeared that the firm, Babcock, and Stead attempted to hide the capital deficiency from discovery by the Commission and the auditors by a deliberate system of failing to post and keep current the books and records, failing to make monthly trial balances of ledger accounts and compute aggregate indebtedness and net capital, failing to inform the auditor of the true nature of status of accounts payable to salesmen, and engaging in financial transactions by which checks were exchanged between Stead and Babcock, drawn against insufficient funds, which "kiting of checks" tended to falsely inflate the cash position of the firm. The exact amount the firm was deficient in capital on any specific day during the period when the "check kiting" was conducted could not be computed with exactness due to the poor quality of the firm's books and the inability of the firm, Babcock and Stead to determine the amount of liability for sales commissions owed by the firm. The Commission further stated that the firm was unable to establish from its records that it was in compliance with Rule 15c3-1 and it could be inferred logically from the above facts that the firm did not have sufficient capital at all times.

As of November 28, 1967, a firm of certified public accountants made an audit of the Babcock firm. It found short positions in securities listed on an exchange which Babcock had handled as agent for customers. The auditors reported to the DRO that customers' long securities could not be located. The inference is that the securities were used in the business. No written consents of such customers could be found, and oral agreements, if any, had not been claimed.

Due to the extensive overhaul required of the firm's books and records, some three months were needed by the firm to bring its books and records into compliance. The firm recommenced business on December 29, 1967. On January 8, 1968, Babcock & Co. resigned its membership on the Salt Lake Stock Exchange. On March 22, 1968, the Commission published an order of public proceedings to determine whether Babcock & Co. had violated the Act of 1933 by selling Triumph Corporation stock and, also, antifraud provisions for failing to disclose an interest in a distribution and in failing to disclose transactions with customers which were in behalf of a securities salesman (Stead) and not in behalf of Babcock & Co.

On December 24, 1968, the hearing examiner rendered his initial decision and recommended that the firm's registration be revoked and its principal officer and Stead be barred from being associated with a broker-dealer except that after a six-month period, they could be associated with a broker-dealer in a non-supervisory capacity upon an appropriate showing that they would be adequately supervised.

By letter and telegram dated December 23, 1968, Stead offered to settle the administrative proceeding insofar as it related to him. On January 3, 1969, Stead was advised by letter that the Division of Trading and Market's (DTM's) recommendation on the offer of settlement would be unfavorable. Notwithstanding this, Stead, through counsel, requested that the offer of settlement be submitted to the Commission for review. He said he was engaged at that time in oral discussions with DRO with a view toward formulating a new offer of settlement. On March 4, 1969, Stead submitted an amended offer of settlement and engaged in additional negotiations with the DRO to see whether the amended offer could be further amended.

Stead was informed by the DTM that it would recommend that the Commission reject the offer of settlement and further informed Stead that the provision in the offer for the imposition of a fine was not consistent with the securities laws. On March 26, 1969, Stead informed DTM that he desired that the amended offer of settlement be presented to the Commission, notwithstanding DTM's adverse recommendaion, and that he desired an opportunity to argue orally before the Commission in favor of the offer of settlement. The Commission granted the petitions of the firm, Babcock, and Stead for review of the initial decision of December 24 of the hearing examiner.

On September 7, 1968, a firm named the Mountain States Securities, Inc. became registered as a broker-dealer in Salt Lake City, Utah. Stead is the firm's president and director and only large stockholder. DTM reported in a memorandum to the Commission on March 28, 1969 that the six months that Stead had been out of business was not a sanction, but simply time necessarily devoted to becoming ready to carry on business.

DTM further reported that Stead's offer of settlement in substance would provide for a thirty-day sanction. DTM stated that this would therefore not be an effective sanction in the public interest, and the violations committed by Stead warrant the imposition of a meaningful sanction and require his future participation, if any, in the broker-dealer business to be strictly supervised by competent supervisors.

DTM stated that the violations committed by Stead had established that Stead was not sufficiently knowledgeable about the securities laws to carry on a broker-dealer business in conformity with the securities laws. Furthermore, DTM stated that Stead had not tendered any evidence to indicate that he had completed a course of study or had otherwise become knowledgeable of all the applicable requirements.

In a memorandum, dated September 11, 1969, to the Commission, concerning an offer of settlement by Babcock, DTM recommended that the offer be rejected. DTM stated that in view of the gravity of the violations that had been committed, it was obvious that the firm and its officer lacked the necessary qualifications and were not fit to operate a broker-dealer business. DTM stated the offer of settlement would permit them to remain in a business which they were not qualified to conduct, and thus expose the public to unneccessary risks.

During the quarter ending June 30, 1969, the Commission granted the petition for review of the hearing examiner's initial decision. Also, during this quarter and the next quarter briefs and reply briefs were filed and the case was argued before the Commission on September 16, 1969.

There was no further information in the Headquarters office files until June 19, 1970, at which time the Commission issued a formal order that revoked the registration of the firm as a broker and dealer; that Babcock & Co. be expelled from membership in the NASD, and that Louis W. Babcock and Robert T. Stead be barred from being associated with any broker or dealer except that Babcock after six months and Stead after three months may become associated with a broker-dealer in a supervised capacity upon an appropriate showing that they will be adequately supervised.

On January 21, 1970, in another proceeding, the Commission issued its findings and order imposing sanctions on Babcock and its principal officer, and another broker-dealer and its principal officer, for the offer, sale and delivery of shares of unregistered stock of Mountain States Development Company, Inc. For Babcock, these violations of the Federal securities laws occurred from January to August 1968. The Commission accepted the firm's and officers' offers of settlement, and as to Babcock, suspended the firm's registration for 30 days and suspended the principal officer from being associated with the firm or any other broker-dealer for 30 days. Both suspensions began on February 2, 1970.

Appendix B–4

BAERWALD & DE BOER

Baerwald & DeBoer, formerly known as Baerwald, Parco, & DeBoer, became registered with the Commission as a broker-dealer May 19, 1966. Since inception, it was a member of the New York Stock Exchange, American Stock Exchange, and the National Association of Securities Dealers.

The NYSE became aware of the firm's financial difficulties in 1969 when it found Baerwald & DeBoer in violation of its net capital requirement at least five times during the year. There was no indication in the files that the NYSE informed the Commission of the violations. It was announced March 3, 1970 that Baerwald & DeBoer had taken steps to liquidate because it couldn't remain in compliance with the NYSE net capital requirement. There was no information in the Commission files which showed what caused the firm to go into liquidation, or who detected the problems. The firm indicated that the capital problem became acute because certain litigations tied up the firm's funds.

The Commission initiated a formal investigation of the firm on August 27, 1969 to determine whether there were violations of certain anti-fraud provisions of the securities laws (promotion of and distribution of certain stocks). In the process of the investigation (December 10, 1969) AMEX informed the Commission that about 70,000 warrants of Leasco Data Processing Corp. had been stolen from Goodbody & Co. Of these warrants, 51,000 had been sold through Baerwald & DeBoer and Hayden, Stone. The Commission reported that because of what they already know about the firm, particularly the sales of stolen securities, it believed that organized crime interests may prove to be the ultimate source of financing and may be in the process of taking over the firm.

The New York Regional Office reported in December 1969 that NYSE and AMEX were making inquiries into the firm. The type and extent of the inquiries, the dates they started and were completed, and the results of the inquiries were not stated. There was no indication in the files of any restrictions being imposed against the firm by the exchanges or the NASD. The NASD involvement, if any, in the problems of the firm was not disclosed.

The NYSE entered into an agreement with Baerwald & DeBoer whereby a liquidator was appointed on April 3, 1970. As of January 4, 1971, the NYSE estimated that $900,000 from its special trust fund will be needed to meet the cost of liquidating Baerwald & DeBoer.

It appears that the Commission let the NYSE and AMEX work with the firm to attempt to solve its financial problems and that the Commission limited its role to conducting an investigation into whether the firm had violated certain anti-fraud provisions of the securities laws in the promotion and distribution of stocks.

Appendix B–5

BARRACO & COMPANY

Barraco & Company incorporated in Utah, became registered with the SEC as a broker-dealer on May 15, 1968. The firm was a member of the National Association of Securities Dealers but was not a member of a national securities exchange. It had one office located in Salt Lake City, Utah.

On November 13, 1968, Barraco filed its financial report as of September 30, 1968 and in the report the public accounting firm commented that (1) the physical safeguarding of securities was not adequate in that a fireproof and burglar proof vault was not being used for the storage of these securities, (2) the accounting system did not adequately control securities in transfer, and (3) the development of an automative accounting system had created problems and errors in the accounting information and position reports.

On May 9, 1969, the Commission stated that it had been advised by NASD that an inspection of Barraco disclosed the firm's net capital ratio was greater than 15 to 1 as of January 31, 1969. Barraco's public accounting firm determined that the capital ratio improved considerably during the next three months (1,099 percent, 907 percent and 789 percent respectively). However, although specific information is not in the files, apparently the situation again deteriorated because on September 2, 1969, a permanent injunction was entered against Barraco pursuant to its consent, followed by an administrative proceeding for violations of Sections 5(a) and 5(c) of the Securities Act of 1933 in the offer, sale, and delivery of Top Notch Uranium and Mining Corporation common stock. The proceeding was terminated by the acceptance of an offer of settlement by the Commission, and Barraco's registration was suspended for 30 days commencing October 1, 1969. During such suspension, Barraco was permitted to engage in certain limited business as specified by the Commission.

On October 20 the Commission received information to the effect that Barraco was experiencing difficulties and possibly would file for bankruptcy. A certified public accountant retained by Barraco advised the Commission that the firm's position record had to be reconstructed, the general ledger and underlying subsidiary ledger were not in agreement and that information relating to bank drafts was inaccurate. The accountant provided the Commission a trail balance as of September 30, 1969, which indicated a net capital deficit of $272,335.

The Commission advised Barraco's counsel that in the event Barraco had not filed a bankruptcy petition by October 27, 1969, it would seek to enjoin the firm from conducting further business and request that a receiver be appointed.

On November 3 the Commission filed a complaint with the U.S. District Court seeking an injunction against Barraco and its three officers from further violations of SEC's net capital and bookkeeping rules. Following this action, on November 5 the Court issued a temporary restraining order against the defendants; however, on the same day, Barraco filed a petition under Chapter XI of the Bankruptcy Act.

On November 14, 1969, the Court, before hearing the Commission's motion for a preliminary injunction, heard and granted motions by the three officers of Barraco to dismiss the complaint as to them. The complaint had alleged that they, as corporate officers, aided, abetted, counseled, commanded, and induced the acts and practices specified against Barraco. The three officers argued that the complaint failed to state a claim upon which relief could be granted against them because none of the individual defendants were brokers or dealers and the statutory provisions alleged to have been violated were applicable only to brokers and dealers.

The Commission's counsel offered to provide authority for the proposition that aiding and abetting principles, which were well established with respect to criminal law, were properly applied in civil proceedings under the federal securities laws and, when applied, supported the request for injunctive relief against the individual defendants. The District Court, however, without significant discussion, accepted the defendants' argument that the relevant provisions of the Securities Exchange Act of 1934 can be violated only by brokers or dealers and that aiding and abetting principles were inapplicable. The Court demanded to be shown a statutory definition of "broker" or "dealer" in the Securities Act that would encompass the individual defendants. The Commission's counsel was unable to make such a showing.

On December 22, 1969, the Commission decided to appeal the court order dismissing the Commission's injunctive action against the officers of Barraco. The appeal, entered in March 1970, was still pending at the end of August, 1970.

On January 9, 1970, the receiver for Barraco informed the court that according to his calculations the assets of Barraco amounted to about $723,000 and its liabilities amounted to about $1,250,000. The receiver said that his main problem was formulating a plan for the liquidation of the securities in Barraco's trading account, which consisted of a considerable amount of low-priced over-the-counter securities. He said he was attempting to work out a plan of liquidation with Intermountain Association of Over-The-Counter Broker-Dealers for the liquidation of these securities.

Appendix B-6

BUCKINGHAM SECURITIES, INC.

Buckingham Securities, Inc. became registered with the Commission on May 23, 1969. It had one office in New York City. The firm was not a member of a national securities exchange or the National Association of Securities Dealers. Buckingham commenced business with an initial investment of $5,000, the minimum required by the Commission.

On January 23, 1970, Buckingham submitted a net capital computation as of December 31, 1969, which showed an excess of capital of $76,000. The Commission's analysis of this data and other Buckingham books and records indicated, however, a net capital deficit of $50,623.87 based on an aggregate indebtedness of $838,000.

The Commission's computation was considerably understated because it was based on information taken from books and records that were not properly maintained and favorable to Buckingham. For example, it appeared that Buckingham willfully understated its liabilities. Customers' free credit account balances were shown as $10,942.00, when, in fact, the total was approximately $202,309.00 according to Buckingham's own figures on the December 31 trial balance.

Further investigation by the Commission revealed bank overdrafts of varying amounts between December 22, and December 31, 1969. On December 31 it amounted to $172,289.31. But on that date a deposit in the amount of $153,539.80 reduced the overdraft to $18,759.00. This overdraft condition continued into January 1970 and reached $119,-571.65. At least nine checks were drawn to pay for various securities between January 9 and 14, 1970 when Buckingham did not have any funds in its accounts. It was alleged that the net capital deficiency increased to $442,570.20 by January 16.

Commission inspections of Buckingham's books and records on January 23, 1970 and on other occasions revealed significant differences and inaccuracies in the books and records. In addition to Buckingham's inaccurate computations of aggregate indebtedness and net capital, the following records were not maintained in an accurate and current manner:

(1) Blotters or other records of original entry containing an itemized record of purchases and sales of securities, receipts and disbursements of cash and other debits and credits;

(2) Ledgers or other records reflecting all assets and liabilities, income, expense and capital accounts; and

(3) Ledgers or other records reflecting (a) securities in transfer, (b) securities borrowed and securities loaned, and (c) securities failed to receive and securities failed to deliver.

On several occasions beginning in early January 1970, Buckingham entered into transactions with other broker-dealers for the purchase of securities with full knowledge that it did not possess sufficient funds to pay for the purchases. On each occasion Buckingham accepted delivery of the securities and made payment by check. Buckingham then stopped payment on the checks before they could be presented for payment. The broker-dealers involved received no satisfactory explanation from Buckingham's officers regarding this action, but later were informed that the trade had been cancelled by Buckingham.

On February 20, 1970, based on a Commission complaint, the U.S. District Court issued a temporary restraining order and placed an asset freeze against Buckingham, its president and two other officers. It also issued an order to show cause why they should not be enjoined from further violations of the net capital and anti-fraud provisions of the Exchange Act. On March 6, the defendants consented to entry of a permanent injunction and stipulated to certain facts; both the consent and the stipulation related to the anti-fraud allegations of the complaint. After a hearing, on March 16, the court granted the Commission request for a receiver and specifically found that Buckingham had been in violation of the Commission's net capital rule on two separate dates.

On May 6, 1970, the president and principal stockholder of Buckingham filed an application with the Commission for registration of a new broker-dealer, Parliament Securities, Inc., in which she was also listed as the president and principal stockholder.

On June 9, 1970, the Commission ordered administrative proceedings against Buckingham and Parliament, the president and principal stockholder of both firms and the treasurer, and secretary of Buckingham. The proceedings were based upon staff charges that since its registration, the firm and the above named officers engaged in various activities violative of the anti-fraud and other provisions of the Securities Exchange Act of 1934. Violations of the Commission's net capital, record-keeping, and financial reporting rules were also alleged. On August 20, the Commission issued its decision under these proceedings in which it revoked the broker-dealer registration of Buckingham Securities and denied registration to Parliament Securities. In addition, the Commission barred the president and principal stockholder of both firms from further association with any other broker-dealer.

The Commission files do not show how Buckingham, starting business with the minimum net capital of $5,000 managed to incur indebtedness of $840,000 and a net capital deficit in excess of $50,000 in a period of just over seven months. This case illustrates what can happen within a very short time to a new firm starting with very small capitalization, and the need to ascertain at an early date how a new firm is complying with the rules and regulations so that corrective actions might be taken before the situation becomes hopeless. In this instance, the Commission did not make its first inspection of the firm until eight months after the effective date of registration.

Appendix B–7

W. R. CAVETT & COMPANY

W. R. Cavett & Company, a sole proprietorship, became registered with the Commission as a broker-dealer on March 15, 1967. It had one office located in Austin, Texas. The firm was a member of the National Association of Securities Dealers but was not a member of a stock exchange.

Cavett's business was primarily the retail sale of registered investment company shares; however, the firm from time to time handled transactions in over-the-counter securities.

The Commission's Fort Worth Regional Office stated it had experienced difficulties with Cavett since the effective date of its registration. Such difficulties had involved Cavett's seeming indifference and failure to adhere to many of the rules and regulations applicable to a registered broker-dealer.

The Commission required Cavett to submit a financial statement monthly from at least August 1968 through May 1969. These statements showed Cavett was a very small firm, and adjusted net (liquid) capital ranged from a low of $664 to a high of $5,437. The Regional Office stated that it and the NASD determined that Cavett was in violation of the net capital requirements at the end of January, February, April and May, 1969.

In an undated memorandum to the Division of Trading and Markets (DTM), the Regional Office reported that in late November or early December, 1968, Cavett agreed to handle the sale of capital securities of Community Savings and Loan Association of Fredericksburg, Texas. Such securities belonged to certain officers and directors of the Association and there was no known market for them outside of a shallow market generated by Cavett, principally among depositors of the Association. Cavett agreed with the sellers of the securities on an arbitrary price of $10 a share plus a 10 percent commission to be paid 30 percent to Cavett and 70 percent to two employees of the Association whom Cavett made his registered representatives. Inspections by the NASD on January 8 and 29, 1969, revealed that Cavett had failed to make and keep certain required records in connection with these securities transactions. Cavett admitted to these violations and the net capital violations to the Regional Office on October 8, 1969.

The NASD filed a complaint against Cavett on June 27, 1969, alleging, generally, violations of the net capital requirements, numerous books and records deficiencies, and violations of NASD's rules of fair practice. On July 18, Cavett filed an answer to the complaint admitting numerous of the allegations.

On September 30, 1969, the Texas State Securities Board revoked Cavett's registration as a securities dealer in the State of Texas after it found at a hearing that:

(*a*) Cavett sold securities from 1967 to 1968 through F. R. Gentry,[1] a former securities dealer whose registration was withdrawn on August 3, 1963, while he was under investigation for violations of the Texas Securities Act.

(*b*) Cavett acted as agent but failed to furnish confirmations to the sellers of the securities of a savings and loan association.

(*c*) Cavett failed to keep and maintain the minimum records necessary to account for the receipt and delivery of securities.

(*d*) although specifically requested to do so, Cavett failed to furnish information deemed necessary by the Securities Commissioner to determine his financial responsibility, business repute and business qualifications, in that he failed to disclose certain material liabilities and outstanding judgments.

In an undated memorandum to DTM referred to previously, the Regional Office recommended the institution of a public administrative proceeding against Cavett and the acceptance of an offer of settlement from the firm and its owner agreeing to the Commission revoking the firm's registration and permanently barring the owner from further association with any broker-dealer.

On January 23, 1970, in a memorandum to the Commission, DTM concurred with the recommendations of the Regional Office and believed they were warranted in view of the seriousness of the alleged violations. DTM noted that Cavett was still registered with the Commission and could resume operations as a broker-dealer outside of Texas. The Commission approved the recommendations on February 3 and issued an appropriate order on February 27.

Appendix B-8

CENTURION SECURITIES, INC.

Centurion Securities, Inc., became a registered broker-dealer with the Commission on July 1, 1969. It had one office located in New York City. It was a member of NASD but was not a member of an exchange. It had an initial capitalization of $7,011, only slightly above the minimum of $5,000.

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[1] F. R. Gentry was the brother-in-law of W. R. Cavett.

The Commission detected operating and financial problems and several possible violations of the securities laws in connection with an investigation ordered on December 10, 1969 of Les Studs Corporation and of Atomic Fuel Extraction Corporation. Centurion's two officers may have had a part in these corporations. Since Centurion only began operations five months previously, sufficient time would not have elapsed to determine whether the problems were readily ascertainable from documents and reports normally submitted to NASD and the Commission.

In the course of the above investigation, the Commission's New York Regional Office (NYRO) sent an investigator to Centurion's office. The investigator found that the firm had a series of problems and violations beginning about September 1, 1969. In addition, it was determined that a large part of the firm's capital as of December 31, was comprised of restricted stock or stock of companies for which no registration statements had been filed with the Commission. The firm could not prove the tradability of these latter stocks. On or about January 22, 1970, the NYRO informed the firm's president that it considered these stocks to be restricted and therefore the firm was not in compliance with the net capital requirements. The firm did not agree.

The NYRO found also that Centurion was violating many "back office" provisions of the securities laws. The firm had not filed its financial questionnaire (X17a-5 report) for 1969 and failed to make and retain certain of its books and records on a current basis in January and February 1970. It appeared that in at least 20 customer cash accounts, Centurion was violating Regulation T in that it did not promptly liquidate or cancel trades when payment was not received within seven business days. The hypothecation rules were also violated.

On February 18, 1970, NASD informed the NYRO that information had been received that the firm's checks were being dishonored. The NYRO ascertained that at least 20 of the firm's checks for over $7,000 had been returned for insufficient funds and that the firm had been refusing to honor drafts presented by other broker-dealers, claiming it did "not know" the trades. NASD also said that as of February 16, Centurion agreed to cease doing a securities business except for the purpose of liquidating long positions and covering short positions, until it had sufficient capital.

On March 3, the firm's attorney advised the NYRO that because the firm's checks were being dishonored and there appeared to be no prospect of obtaining additional capital, Centurion would consent to an injunction and the appointment of a receiver.

On March 12, the NYRO filed a complaint in the U.S. District Court. On the same day the Court issued a permanent injunction decree and appointed a receiver.

On March 11, 1970, the NYRO ordered a continuation of the investigation of Centurion to see if there were other violations, to obtain an injunction against Centurion and the president on the remaining count (fraud in the sale of two stocks), and to obtain an injunction against the firm's vice president who had disappeared. In addition, the two firms involved in the fraud count, Underwriters Investment Company and Drexal Industries, Inc., were being investigated by the Fort Worth Regional Office.

The Commission does not know whether there will be any losses incurred in the liquidation of the firm.

Appendix B–9

CHARTER SECURITIES CO., LTD.

The Charter Securities Co., Ltd. became a registered broker-dealer with the Commission on June 30, 1968. It was a member of the NASD but was not a member of an exchange. Charter had one office in New York City which dealt in over-the-counter stocks, and underwriting and the sales of mutual funds. It commenced operations with net capital of $5,000—the minimum required by the Commission.

Charter's financial difficulties were detected by the Commission through an analysis of a financial report as of August 31, 1969 which revealed a net capital deficit amounting to $46,626. Charter was notified of this deficiency on January 21, 1970 and given until January 28 to conform with net capital requirements. Also, attention was called to the prohibitions to effecting security transactions while the firm's financial condition does not conform to capital requirements.

Charter obtained the necessary capital in a timely manner by means of a contribution by the president of a number of shares of stock. However, on March 18 the Commission was informed by NASD that an inspection disclosed that Charter again had net capital deficiency as of February 28 amounting to $75,000. Also, as in the case of the previous deficiency, NASD requested Charter to cease doing business until NASD was satisfied as to the accuracy of the books and records and that there was capital compliance.

In addition to the capital deficiency, the Commission alleged in a complaint filed in the U.S. District Court on April 14, that Charter misappropriated funds obtained from an underwriting. Under the terms of the offering it is stated that subscribers' funds would be deposited in a special account and that if subscriptions did not amount to $300,000 within ninety days from January 16, 1970 all funds would be returned to subscribers. By April 14 (88 days after January 16) Charter raised only $113,000 and no part of these funds were deposited in the special account. The Commission also charged that Charter sold the stock by use of false and misleading statements in the offering circular. The court agreed with the allegations and on April 15 (the following day) issued a preliminary injunction from further violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and appointed a receiver for the business and its assets. On May 18 Charter submitted a trial balance as of April 10 reflecting the missing escrow funds and a capital deficiency of $179,000.

The Commission is pursuing violations pertaining to the net capital rule and the rules governing fraudulent acts by broker-dealers. An estimate cannot be made as to whether there will be any customer losses.

Charter was operating for only a little over one year when capital problems developed. It is significant to note that although the capital problems were reflected on financial reports as of August 31, the Commission was not aware of them until January 21. It would appear that the Commission should take corrective action by requiring more timely reporting. Also, the Commission became aware of the second capital problem on March 18 but a temporary injunction was not sought until April 14 which appears to indicate a need for more timely action.

Significantly, the Commission files do not reflect the cause of Charter's capital problems. It would seem that in the interest of public protection, the Commission should take an interest in the cause of broker-dealers' financial difficulties, beyond the mere determining of the existence of violations of present statutes and rules, in order to ascertain whether there is a need for additional legislation or regulation.

Appendix B–10

CUTTER & COMPANY

Cutter & Company was a sole proprietorship owned by Mr. Saul H. Cutter. The firm's registration with the SEC was effective August 24, 1962 and in September 1962 it was admitted to membership in the National Association of Securities Dealers; it was not a member of a stock exchange. Cutter had one office located in Brookline, Mass.

Cutter's financial and operating problems go back at least as far as March 31, 1965, when a SEC inspection disclosed that Cutter needed $10,941 of additional capital to comply with the net capital rule. The inspection also disclosed that various bookkeeping rules were not being fully complied with. Another inspection as of January 31, 1967, again disclosed violations of the record-keeping rules; and the next inspection as of December 4, 1968, revealed violations of the hypothecation and record-keeping rules. After each inspection Cutter assured the SEC Boston Regional Office that steps would be taken to correct the deficiencies.

On October 3, 1969, the NASD censured Cutter and fined it $500 for failing to make a bona fide public offering of 200 of its 300 share participation as a member of a selling group of American Snacks, Inc. stock.

Cutter's financial problems became critical after December 31, 1969. The firm's financial questionnaire for calendar year 1969 showed that during December it was in violation of the net capital requirement but as of December 31 this was overcome by the owner making a cash contribution of $78,000 to the firm.

The next SEC inspection was on May 15, 1970, after Cutter refused to allow NASD representatives to inspect its books and records. The inspection disclosed that as of April 30, Cutter had aggregate indebtedness of $61,938, a net capital deficit of $229,352, and additional capital of $341,876 was needed. Another capital computation by SEC as of May 15 showed that the firm's deficit had increased over $122,000 to $351,595 in a period of only 15 days. At that time Cutter needed $429,700 of additional capital. Its liabilities amounted to $645,307 and its assets were $296,969. Both the April 30 and May 15 inspection reports stated that Cutter was insolvent. In March and April Cutter ordered almost 6,000 shares of stock ranging from $27.375 to $51.625 a share, but declined delivery in May. SEC stated the stocks had dropped from $11 to $23 a share.

As noted previously, SEC inspected Cutter four times between March 31, 1965 and May 15, 1970. On May 21, 1970, SEC filed a complaint with the U.S. District Court requesting a preliminary and final injunction and the appointment of a temporary and permanent receiver for the firm. The Court granted a temporary restraining order and appointed a temporary receiver on May 22. On May 28, the Court granted a preliminary injunction against Cutter and continued the receiver in office.

Cutter seems to be another case of a firm struggling along through infusions of additional capital from time to time. However, in March and April 1970, Cutter apparently made some bad trades for the firm account which caused its downfall. Cutter declined delivery of over $264,000 in stocks it had ordered from other broker-dealers. This was probably a contributing factor for one of them, Henry J. Richter & Co., failing.[1] This case also is another example of the difficulty that will be encountered by SIPC whereby considerable losses can be incurred in a short period of time without the knowledge of those responsible for surveillance.

Appendix B-11

DEMPSTER INVESTMENT CO.

The Dempster Investment Co., a Michigan corporation, was organized on February 27, 1964, to engage in and carry on a general brokerage and financial business, including mortgage brokerage and financing thereof. The corporation never filed for registration with the Commission as a broker-dealer. The corporation authorized 15,000 shares of common stock at a par value of $1.00 per share. The incorporators, Phyllis Dempster and her husband, Alexander Dempster, each subscribed to 5,000 shares of the common stock.

Mrs. Dempster was the president and chief executive officer of Dempster since its inception. Mr. Dempster was in ill health for a number of years and did not participate in the activities of the firm and was not involved in the transactions discussed below.

The Commission learned that since at least January 1968, Mrs. Dempster had been offering for sale and selling promissory notes and evidences of indebtedness issued by the corporation, based on an invalid claim of exemption from registration pursuant to Section 3(a) and 3(a) (11) of the Securities Act.

The problem was first revealed on March 6, 1969 when a Michigan resident called the Commission's Detroit Branch Office and inquired about the Dempster Investment Company. He stated that the company was offering notes in multiples of $1,000 bearing interest of 5 percent per month and asked whether the company was registered with the Commission.[2] A search revealed that the company was not registered. The individual was advised accordingly.

It was not until June 20, three and a half months later, that an attorney with the Detroit Branch Office met with Mrs. Phyllis C.

[1] Case study, Appendix B-38.

[2] On November 12, 1969, the Assistant Director, Securities Bureau of the Michigan Department of Commerce, called the Detroit Branch and stated that he had also received a call from a Michigan resident. This individual stated that he had an offer from Dempster to invest $10,000 at 5 percent monthly and inquired whether the company was registered.

Dempster (and her attorney) to inquire about the promissory note issued by the company.

Mrs. Dempster stated that after exhausting her personal resources, she, on behalf of Dempster, had sold notes of 30, 60 and 90 day duration, exclusively to residents of the State of Michigan, and that she had made no use of the mails. She said that the money borrowed by means of the short term notes was used to pay operating expenses. These notes, Mrs. Dempster said, were sold in multiples of $1,000 and were sold mostly to clients with whom she dealt in a business capacity over the past 10 years, and to friends of these clients.

Mrs. Dempster further stated that she did not know the total value of the notes issued and could not venture an estimate at that time. She stated that notes were issued at interest rates of up to 5 percent for 30 days when funds were urgently needed. She stated that interest was paid monthly and that Dempster had never defaulted on payment of a note and that all notes had been honored when redemption was requested.

The Detroit Branch Office attorney advised Mrs. Dempster that the sale of these notes might constitute violations of the registrations and antifraud provisions of the Federal securities laws. Mrs. Dempster stated that she would not sell any more notes until the books and records were inspected.

Mrs. Dempster stated on July 14, that she had stopped issuing notes; that she would repurchase all outstanding notes within the next 90–120 days, and that a letter "explaining the situation" would be sent to all Dempster note holders.

Also during the June 20 meeting, the Detroit Branch attorney requested and Mrs. Dempster promised to provide a list of the noteholders, including names, addresses, amounts, repayment schedules, and renewal of notes. She requested and the attorney agreed that she be permitted to delay the preparation of this material until after an inspection by the Commodity Exchange Authority of the American Commodity Brokers—a subsidiary of Dempster Investment Company. Mrs. Dempster or her attorney was contacted during each of the months of July 1969 through January 1970 and requested delivery of the records as promised. On each of these occasions the Detroit Branch Office was assured of the complete cooperation of Dempster Investment Company and that the information would be available shortly. It was not until January 7, 1970 that a deadline (January 20) was insisted upon. In fact, the information was not furnished but rather obtained by the SEC during the course of an investigation January 15. As pointed out below, the delay in obtaining the information and taking firm actions had pernicious effects because the amount of outstanding notes more than doubled during this period.

On January 7, 1970, the Michigan Securities Bureau informed the Detroit Branch Office that it had several complaints about Dempster and that according to the balance sheet the company was insolvent. The Bureau also stated that it would start an investigation of the company and coordinate it with the Detroit Branch Office. The investigation was commenced on January 15. The timing was probably prompted by the fact that on January 13 Mrs. Dempster called and stated that she had floated a series of notes since June 1969, and that Dempster was insolvent to the extent of $475,000. This information was surprising in view of the fact that two months previously (November 13) Mrs. Dempster had stated that she had made no sales of notes in the past several months, and that she was "closing out—returning all loans."

1. During the period December 31, 1968 to December 31, 1969, notes payable, not including interest, had increased as follows:

As of:	
Dec. 31, 1968	$259,867
June 30, 1969	621,931
Sept. 30, 1969	725,242
Oct. 31, 1969	811,667
Nov. 30, 1969	774,793
Dec. 31, 1969	1,302,463

In addition, at December 31, 1969, there were loans payable to officers in excess of $400,000. The interest had not been calculated and included in the above amounts because the books and records had not been currently maintained.

The December 31, 1969 balance represented 443 notes outstanding. The purchasers were not told of the financial condition of the company and were furnished no written or oral financial information about the firm.

2. The notes outstanding in the hands of the public investors had maturity dates ranging from 30 days to one year. Many had been renewed two or more times. They were redeemable on 30 days' notice, regardless of maturity. Interest rates of these notes ranged from 2 percent to 12½ percent monthly, with individual face amounts between $1,000 to $5,000.

3. The notes had been sold primarily to residents of Michigan, but purchasers residing in Ohio, California, Illinois, and Arizona also had bought notes. The United States mails were used in the offer, sale and delivery after sale of the notes in question.

4. For the eleven month period ending November 30, 1969, the company had a loss of $815,241. It paid interest to holders of notes in the amount of $733,111 while the total income from operations for the same period was $184,794.

5. Mrs. Dempster invested about $450,000 of her own assets during the past several years. She was also president of Dempster Oil and Gas Company, and of American Commodity Brokers—subsidiaries of Dempster Investment Co.

As a consequence of these findings, on January 23, the Detroit Branch of the Securities Bureau, Department of Commerce of the State of Michigan, issued an Order to Cease and Desist on the Dempster Investment Company and its president, Phyllis Dempster. However, it also informed the Commission that the Attorney General of the State of Michigan would not seek an injunction or a receiver. The Attorney General said that the Commission should initiate the enforcement action since a Federally appointed receiver would have more power.

Previously, on January 21, the Chicago Regional Office recommended that the Commission authorize the filing of a complaint for injunction naming the Dempster Investment Company and Phyllis Dempster, to enjoin further violations of Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933; Section 10(h) of the Securities

Exchange Act of 1934, and Rule 10b-5 thereunder in connection with the offer and sale of promissory notes and evidences of indebtedness issued by Dempster Investment Company, and seeking the appointment of a receiver for the company.

It was not until March 6 that the Commission acted on these recommendations. On this date the Commission filed a complaint and motions for a temporary restraining order, a preliminary injunction and for the appointment of a receiver. The court issued a temporary restraining order on March 10, issued a preliminary injunction against the defendants on March 20, and appointed a conservator and trustee on March 27. However, four days later the conservator and trustee petitioned the court to be relieved of his duties. In the petition he stated that based on an examination of Dempster Investment Company and its affiliated and subsidiary companies, and the books and records thereof, he concluded that:

(*a*) There are no assets of Dempster Investment Co. to conserve or preserve.

(*b*) Insufficient funds exist even to pay for:

(1) A complete audit of the books and records of Dempster Investment Company; and

(2) Current wages, salaries and other expenses.

(*c*) Dempster Investment Company is totally insolvent.

The court ordered the conservator and trustee be relieved of his duties.

Final judgment was issued by the court providing that Dempster Investment Company, Phyllis C. Dempster, and their agents, servants, and employees, and each of them, be permanently enjoined from selling any securities until a registration statement was in effect with the Commission to sell such securities.

We do not believe the Commission acted expeditiously in this case. The Commission failed to take any action for three and a half months after being informed that Dempster was selling promissory notes having extremely high interest rates and was not registered with the Commission. A temporary restraining order and a preliminary injunction against the firm and its president was not sought for a full year. Also, the Commission allowed Dempster to stall for seven months the furnishing of a list of the note holders. Meanwhile, the amount of notes outstanding more than doubled ($680,000). It appears that the full value of the notes outstanding ($1,300,000) will be lost by the investors in the firm.

Appendix B-12

DOORLEY & CO., INC.

Doorley & Co. became registered with the Commission as a broker-dealer on December 12, 1966. The applicant requested acceleration of its registration from January 4, 1967 (normal 30 days) to December 8, 1966 (3 days after filing date) in order to coincide with the anticipated effective date of membership in NYSE. The Regional Administrator of the Boston Regional Office (BRO) recommended acceleration on December 12 apparently based solely on an examiner's report ences for applicant nor principals." The Commission's records do not that a Commission record search revealed "no SV nor Complaint referindicate any other investigation of the applicant—apparently the Commission was relying on NYSE but it had no assurance NYSE membership would be approved.

The financial report filed with the application for registration indicated cash of $25,000 as the only asset and no liabilities. The statement was notarized but no audited and apparently not verified by the Commission.

The original application listed three directors, but without recorded explanation, the revised application lists two directors: William R. Doorley and Judson S. Smith. Mr. Doorley is listed as having five years (January 1961 to February 1966) experience with Diamond Doorley Douglas and Co., Inc. (Providence, Rhode Island) as chairman of the board, vice president and shareholder. Mr. Smith is listed as having 10 years experience—November 1952 to Septemer 1959 with DeCappet and Doremies (NYC) as associate broker—September 1963 to December 1963 with State Street Securities Inc. (NYC) as director, and December 1963 to July 1966 with Lawrence H. Douglas Co., Inc. (NYC) as vice president, director and shareholder. The original application indicates that Mr. Smith was a member of NYSE from July 1966 to present (December 1966) but this fact was not included on the amended application. There is no evidence that the Commission verified this information or had any other information pertaining to the applicant. It would seem to have been important for the Commission to know whether the directors left their previous employers under favorable conditions, were educationally qualified, etc.

A memo dated March 11, 1969, states that Mr. Doorley is about 33 years of age. Another memo, dated February 28, 1969, described Doorley as "young, frivolous and irresponsible." It is doubtful that these were latent developments and it therefore appears to have been incumbent upon the Commission to have investigated Doorley before approving his application for registration. Although based on existing criteria the Commission may not have been in a position to bar registration, it would at least have been alerted to the possibility of difficulties. For example, investigative reviews could have been made sooner and applications for time extension for filing financial data more carefully scrutinized or denied.

The first financial statement was received from CPA firm on June 28, 1967 for the questions on the financial questionnaire as of May 31. No exceptions were noted.

The second financial statement was received August 12, 1968 (after being granted a 30 day extension) for information as of May 31. The CPA was unable to express an opinion because:

1. Legal records consisting of corporate minute book and stock transfer records were not available.
2. Confirmation not received from Herzfeld & Stern, the broker carrying the omnibus account, despite repeated requests.
3. Inability to confirm the receivable of $17,000 shown as subordinated loan.
4. Customers' security position records could not be reconciled since these records were completed August 1, 1968. For this reason, security valuations were omitted from the Answers to the Questionnaire.

These deficiencies plus a number of other infractions (mostly minor) were brought to the attention of Doorley by a letter from the Commission dated August 20.

Significantly, neither the audit report nor the SEC letter mentioned the net capital ratio. As described below, AMEX subsequently informed the Commission that the financial statement reflected a net capital violation and that there had been a problem since May. BRO officials explained that in many instances they do not compute the net capital ratio for exchange members. The same financial data furnished the Commission is furnished the exchanges and it is the responsibility of the exchange to enforce this requirement. Nevertheless, it would appear that the Commission should at least be aware that a violation exists. It is ridiculous for the Commission to point out to the registrant, for example, that "your report, pursuant to the Rule, should have been filed with this regional office and not in New York" or that the report did not contain the required facing sheet, and then omit the most serious violation, namely that there was a violation of the net capital rule.

On August 27, the CPA advised that the stock records were not made available to him "until the end of July." He continued:

> The company had been updating their records to current status and this work was not completed until the end of July. At that time my manpower situation had deteriorated so as not to allow me to complete a certified audit. Doorley & Co., Inc. is now making arrangements for retention of new independent auditors . . .

The fact that these records were not made available until the end of July is significant because the audit report was due to be filed July 15. Moreover, on July 10 Doorley wrote the Commission stating the audit was in process and requested a 30 day extension. The Commission apparently accepted Doorley's explanation that the CPA was at fault due to his lack of manpower and experience.

Another audit was commenced by another CPA firm on September 30—three extensions for submission (to December 2) were requested and approved. The certification for this audit was received December 3 but contained the following qualification:

> A broker holding an omnibus account was unable to reconcile at this date the cash position of the account which is carried in the accompanying answers to financial questionnaire in the net amount of $45,407.24 long and was unable to reconcile certain long and short security positions. Because of the inability to reconcile at this date, the broker was not able to confirm the aforementioned long cash position nor certain long and short security positions. The cash and security positions not confirmed are material to the financial position of Doorley & Co., Inc. at August 30, 1968.[1]

The BRO informed the NYRO of this qualification because it indicated the possibility of a back office problem for the broker holding the omnibus account (Herzfeld & Stern). However, the files do not indicate that BRO took any other action. This is particularly surprising considering, as described below, that the inspection of Doorley on September 4, 1968 revealed a net capital ratio of 1,940 percent, a large operating deficit, and other warning signals.

On October 16, 1968, Doorley advised that four persons resigned as "Allied Members and Voting and Non-Voting stockholders" and that two persons (one was Edward M. Doorley, a brother of the presi-

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[1] Reconciliation is required by Rule 17a–3(a)(3).

dent) resigned as registered representatives. This certainly also should have been a warning to SEC that Doorley had problems and action should have been taken based on the auditor's qualification.

The auditor also appears to have been remiss in the certification of the financial report. Although the audit was for the questionnaire as of August 30, the report was not issued until November 27 and the auditor has the responsibility to note significant developments occurring after the audit effective date. The auditor therefore should have noted that on or about October 31, Doorley ceased to do a retail business. Conceivably, he also could have noted that commencing in November Doorley "conducted business without maintaining the books and records required under Rule 17a–3."

Investigations

The Commission made its first inspection on October 31, 1967, covering the first ten months of operations from December 1966 to September 30, 1967. The investigation did not reveal any discrepancies.

The Commission's second inspection was on September 4, 1968—ten months after the first inspection. The report states that in addition NYSE conducted an inspection March 30, 1967 (four months after operations commenced and seven months before SEC's first inspection) and NASD conducted an inspection May 2, 1967. The report indicates that the NYSE membership was withdrawn August 8, 1968.

The inspection revealed that there had been considerable expansion in the last year. There were 13 voting shareholders (as opposed to two at inception) and 17 registered representatives. There was an average of 47 daily customer transactions as opposed to 19 six months earlier; there were 1,200 open accounts as opposed to 600 six months earlier.

The report indicates that record-keeping was current. However, this fact is challenged by the AMEX whereby it informed the Commission that "the books and records were in a mess and the firm unsuccessfully made efforts to effect a merger with another firm." AMEX's contention is substantiated by the fact that the auditors were unable to certify the March 31 and August 30 statements because, among other things, the omnibus account could not be reconciled, and the cash and security positions could not be confirmed. This error in the Commission report would seem to cast a serious doubt on the quality of its inspection.

A net capital computation as of July 31 showed a ratio of 1,940 percent based on aggregate indebtedness of $2,526,710, net capital $130,241, equity capital $303,999 and subordinated capital $287,199. As the maximum allowable ratio is 2,000 percent, this company was approaching the point of violation and restrictions should have been imposed to assure that a violation would not occur. Moreover, at this time AMEX supposedly had Doorley on a 1,500 percent net capital restriction based on the financial data submitted in August 1968 for the period ending March 31, 1968.

The income and expense statement for the period ending August 30, 1968 shows a deficit of $89,541.97 and a deficit for the prior year of $96,152.87. There was apparently a rapid deterioration because a financial statement for the year to date as of July 31 (one month earlier) shows as deficit $32,465.03. The deficit increased to $111,199.39 by February 29, 1969. The August 30 statement shows commissions earned were $1,371,801 out of a total income of $1,405,819 but commissions paid brokers were $560,993 and salaries and commissions paid were $617,103 (total $1,178,033). Doorley was apparently aware that commission income was not sufficient in relation to expenses to make a profit because the inspection report states that an order was issued discouraging transactions in low priced securities and that "salesmen do not share if total commission charged customer is under $20."

It would appear that this bleak financial report should have put the Commission on notice that serious financial difficulties were pending. However, the files do not indicate that the Commission took any action.

Liquidation

The Commission first became aware of Doorley's financial difficulties on February 27, 1969, when representatives of AMEX visited the NYRO to explain the matter. NYRO informed BRO by a memorandum dated February 28.

AMEX explained that in addition to the net capital violation reflected in Doorley's financial statement as of March 31, 1968, mentioned above, there had been a continual net capital problem from about May, 1968 to date (February 1969). It was further stated that the "books and records were in a mess." As a consequence Doorley sold its AMEX seat on January 30, 1969. The sale realized $340,000. However, in order to insure that customers and other broker-dealers were protected, the AMEX took possession of the proceeds. Also, it was stated that Doorley was indebted in the amount of about $180,000 to public customers (exclusive of subordinated lenders).

AMEX further informed NYRO that:

> . . . Doorley's mother was a subordinated lender of the firm, and contributed securities owned by and registered in the name of the two brothers. The latter disclaimed that they endorsed the stock certificates involved or authorized the use of their securities for the purpose of the subordinated loan. It would appear that their signatures were forged. The mother died in December 1968 and the securities are pledged with the Chemical Bank New York Trust Company to secure a loan made to the firm. . . . The AMEX sought authority from William Doorley to permit the Chemical Bank New York Trust Company to allow AMEX representatives to examine the stock certificates but Doorley refused.
>
> We were also informed that the books of the firm show that William Doorley acquired additional stock of the corporate firm for which he purportedly paid $53,000. It appears that he negotiated a personal loan from the Greater Provident Trust Company in the amount of $53,000 under a restriction whereby these funds were never to be taken out of the bank account. This is obviously a very peculiar arrangement which requires intensive inquiry since, under the circumstances, these funds were never really available to the firm and their inclusion on the books as part of the assets of the firm may constitute a false entry. Accordingly, the firm's Rule 17a-5 report may also, to this extent, be false.

As a result of this information, BRO commenced an inspection of Doorley on March 3 and ascertained the following:

1. Current liquid assets per books were $515,667 and current liabilities $921,258. After adjustment for information not in the books current assets were $342,419 and current liabilities $939,824.
2. The registrant had not reconciled its omnibus accounts with Herzfeld & Stern. Doorley claimed H & S owed Doorley $95,040 whereas H & S claimed Doorley owed H & S $69,815.
3. The $53,486 balance with the Greater Providence Bank was restricted "until certain personal loans made by William

Doorley and Nicholas Taylor (stockholder) were paid. The bank president claimed the loan ($53,000) was made by Doorley for capital purposes to be shown AMEX. Moreover, Doorley's ledger account did not show that this debit balance of $53,486 was restricted.

4. The last postings of the stock records were made October 31, 1968. Doorley stated that the firm stopped doing business with the general public around October 31.

As a consequence of these findings, on March 11, 1969, DTM recommended that the Commission authorize the filing of a complaint charging violations of the Commission's bookkeeping rules and seeking a permanent injunction, as well as appointment of a receiver.

This memo summarized many of the facts enumerated above. It also brought out

Early in 1968 the NYSE raised a question of the subject's net capital ratio. Evidently the firm obtained additional capital through subordinated loans and as of July 19, 1968 the firm appeared to have capital of $54,000 in excess of exchange requirements, giving it a 1,234% ratio. On August 8, 1968, the subject firm retired as an NYSE member, and its seat was sold.

With regard to the March 3 inspection, this memo reports different findings in that:

. . . current assets were approximately $62,500 and its current liabilities $171,500; that it had approximately $650,000 in subordinated debt; that customers were owed approximately $92,000 in cash and it could not be ascertained, because of the condition of the books, what securities were due to customers.

With regard to the proceeds from the sale of the AMEX seat and the forged securities owned by Doorley's brothers this memo reports:

. . . In March 1969, William F. Doorley requested the AMEX to release $60,000 of the proceeds of sale of the seat so that this amount could be paid to brokers, thereby releasing customers' securities. AMEX granted his request, but instead of applying this cash, as represented, Doorley used it to reduce a $185,000 firm bank loan at the Chemical Bank in New York, and thereby obtained release of certain collateral of securities registered in the names of Doorley's brothers, Robert and James.

The chronology of court proceedings follows:

Item	*Date filed*
Complaint, enumerating the various violations of laws	Mar. 11, 1969
Affidavit of inspector explaining findings of the Mar. 3 inspection	Do.
Motion for preliminary injunction and appointment of receiver	Do.
Notice of motion, hearing set for Mar. 18	Do.
Order appointing receiver	Mar. 14, 1969
Affidavit of SEC attorney indicating that Chemical Bank & Trust Co. of New York was advised of appointment of receiver	Mar. 17, 1969
Application for classification of creditors determination of subordination and authority to sell securities	May 5, 1970
Order to classify creditors under Sec. 60E of the Bankruptcy Act and to determine subordination of certain creditors and authorizing the sale of securities	Do.
Order for private proceedings and notice of hearing pursuant to Sec. 15(b) and 15A of the Securities Exchange Act of 1934[1] (draft only)	May 20, 1970

[1] The justification for these proceedings is contained in a memo from BRO to DTM dated May 7, 1970.

On July 11, 1969 a BRO investigator and an attorney visited Doorley. This visit revealed that the last postings to records was October 1968 and that records did not agree with customer ledger cards in some instances. The receiver was unable to identify the owners for a considerable number of securities.

On June 8 and 9, the BRO investigator visited AMEX and reviewed the files to ascertain if there was any evidence proving fraud on the part of Doorley. For the most part the findings discussed above were substantiated. One additional fact brought out was that Doorley forged one of the subordinated loan agreements (amount not given) on September 16, 1968. A memo dated June 23, 1970 states that in AMEX's opinion the capital problems were due to mismanagement. It also states that there is:

> A memo to the files from John McLoughlin (AMEX) in conference with William F. Doorley in which reference is made to restrictions to cash pledge of securities owned by Doorley's brothers for loans to be used in the business, written guarantees against losses that were given to shareholders, and cash advances made to employees, which helped lead to the financial difficulties of the firm.

On May 15, 1970, BRO requested and received from Doorley's attorney a list of customers of Doorley claiming non-delivery of securities. The list shows 42 persons with various amounts of securities. The list noted that some of these customers, without reference to how many, had executed subordination agreements. The attorney also stated that he "is not certain if there will be sufficient moneys available to pay all creditors."

Doorley's attorney, in a letter dated August 7, 1970, states:

> Thirty-seven claims have been filed by persons who would appear to be customers of the bankrupt. The total amount claimed by these claimants is $87,748.14. Of this amount there would appear not to be owing, according to the books of the bankrupt, $27,601.11 thus leaving clearly owing to these customer claimants $60,147.03.
>
> Seven priority claims have been filed for a total amount of $3,253.17.

The assets presently held total $314,847. There are also 32 other claims (non-customers) totaling $182,050, and subordinated creditors claims of $386,345. Therefore, it would appear that the customers will be paid in full.

Conclusion

This case illustrates the necessity to strengthen the requirements for registration. Although Doorley had considerable funds beyond the $25,000 original capital indicated, he did not have the character necessary to be a broker-dealer. The financial difficulties were apparently caused by mismanagement in that proper records could not be maintained. When they developed Doorley forged documents and otherwise committed fraud resulting in substantial losses to creditors (but not customers).

The case also points out that Commission investigations are not accurate and that apparently too much reliance is placed on the exchanges for surveillance.

This case has an unusual aspect in that the broker-dealer sold his seats on the NYSE and AMEX before the extent of his difficulties became known. AMEX did withhold a considerable portion of the proceeds from the sale of the seat in order to protect other broker-dealers and customers. However, no mention was made of the exchanges committing trust funds to assure that customers would not incur losses.