Appendix B–13

FRANCIS I. DUPONT & COMPANY

Francis I. duPont & Company became registered with the Commission February 9, 1940. It is a member of the New York Stock Exchange, the American Stock Exchange, certain regional exchanges, and the National Association of Securities Dealers. Because of serious financial and operating problems duPont merged with Glore, Forgan & Company on July 1, 1970. This was followed by a second merger with Hirsch & Company. The two mergers gave the new firm 141 branch offices operating under the name of F. I. duPont, Glore, Forgan & Co.

duPont was beset with severe financial and operational problems since 1968 and the problems had not been resolved as of the end of January 1971.

The NYSE monitored and assisted the firm in attempting to overcome its problems. The Commission was aware that duPont was having problems, but it apparently was not aware of their severity and did not evaluate the adequacy of the actions taken by the NYSE for over two years. It was not until the fall of 1970 that the Commission reviewed documents at NYSE bearing on the financial and operational condition of duPont over the past two years, the NYSE's knowledge thereof, and the NYSE's performance as a self-regulatory body. The Commission's primary effort was directed to getting duPont to improve its complaint processing procedures and at the same time to take the necessary actions needed to improve the back office difficulties that were causing the numerous customer complaints.

On August 29, 1968, duPont filed its financial report as of June 30, after an extension of time had been granted. The report showed 4,600 security count differences from duPont's records, having a value of long[1] $29,875,000 and short[2] $5,383,000. The firm counted the securies in its box[3] once a year on a cycle basis. The cyclical counts of its box revealed a continuing number of security count differences affecting the accuracy of its stock record and customer accounts. The Commission stated the number of stock security count differences uncovered in the cyclical counts appears to be of a magnitude equal to that uncovered in the June 30 audit.

The August 1968 report also showed that the beneficial owners could not be identified for $6.5 million in securities received from transfer agents. (This was reduced to $1.8 million by December 10, 1968.)

In October 1968 the NYSE restricted duPont as to its advertising, new branch offices and additional registered representatives. The restrictions were removed January 13, 1969.

An NYSE examiner visited the firm during the period from December 30, 1968 through February 13, 1969. Numerous operational problems were discussed with the firm, and various capital computations were made as of November 30, 1968. Whereas the firm computed its capital ratio on that date as 1,756 percent, the NYSE examiner arrived

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[1] A term used to indicate securities for which a firm does not know who the owners are.

[2] A term used to indicate that the firm owes securities to customers or other broker-dealers but cannot locate the securities.

[3] The physical location in the cashier's department where available securities are kept to meet immediate obligations such as transfer or delivery.

at eight different computations as of this same date, ranging from 1,568 to 2,475 percent. The differences depended on the treatment of such items as short stock differences, suspense accounts, and fails to deliver.

The Commission stated that the technique of multiple computations was not peculiar to this situation but had been used in other cases, as well as for duPont on other occasions. The NYSE decided to use the capital computation which put the ratio at 1,902 percent as of November 30, 1968. However, it was also indicated that the NYSE imposed a charge for old fails to deliver items, as of December 1, 1968, which charge had the effect of raising the firm's net capital ratio to 2,387 percent.

On March 11, 1969, the Commission ordered the institution of private administrative proceedings against duPont to determine what remedial action, if any, should be taken against duPont for failing to accurately maintain and keep current certain of its books and records, and whether it was necessary in the public interest and for the protection of investors to suspend the firm's registration.

During 1968 duPont had experienced a tremendous growth in its business. In January 1968, it had approximately 62,000 active accounts, whereas this number increased to 180,000 in September, and was 223,000 by the end of December. The number of registered representatives and producing partners had also increased in 1968 from 1,365 in April to 1,620 in December. The firm spent $1.4 million in promotional advertising in 1968. However, public complaints also rose in proportion to the increases in business. From December 1, 1967 until January 29, 1969, duPont received 45,269 complaints. These complaints dealt mostly with failure to deliver securities, moneys, or dividends to customers or accounts in error. In 1967 the Commission received 116 complaints rising to 441 in 1968, and in January of 1969, a total of 81 complaints were received.

The Commission stated that duPont had so many customer complaints at one time that it had no idea of the number it had received or their status. Furthermore, it was taking duPont two to six months to even acknowledge a complaint. This is one reason why the Commission stated it was bringing proceedings in order to compel duPont to take necessary corrective measures. The Commission stated that it had suggested to the NYSE to go beyond fails statistics and recordkeeping differences as a criteria for determining whether a firm is complying with all applicable requirements and suggested that they examine complaints as a barometer to determine compliance.

The Commission noted that its action against duPont was in furtherance of its Release No. 8363 which cautioned brokers that it is a violation of the applicable anti-fraud provisions for a broker-dealer to induce or attempt to induce or to accept or execute an order to purchase or sell a security if it does not have the personnel to promptly execute and consummate all of its securities transactions. Accordingly, the Commission stated that it believed it was appropriate to institute administrative proceedings ordered on March 11, 1969, to insure that the firm would take steps to improve procedures or to hire additional personnel as necessary to properly and effectively handle customer transactions. duPont established a customer service department in the

fall of 1969. The firm claimed that they were up to date as of December 15, 1969, with complaints, and had a target of resolving complaints in 7 business days (except delivery and mishandling problems). This conflicts with an NYRO report in the quarter ending December 31, 1969, that duPont's customer complaints were still coming in at a rapid rate and that the firm may have financial difficulties.

The NYSE stated that during the 14 month period from September 1, 1968 through October 31, 1969, despite clear warning of an unsatisfactory condition, the firm was (1) the subject of the greatest number of complaints of all the firms of the NYSE; (2) at the end of the period it had more than twice as many complaints open and unresolved as any other firm; (3) during the period the firm took 76 percent longer to resolve customer complaints than other firms; and (4) during the last five months of the period, despite continuing warnings, the firm continued to have the largest number of outstanding complaints over 60 days old.

In March 1970 the NYSE fined the firm and certain of its partners a total of $110,000 for the failure to promptly resolve customers' complaints.

An NYSE examiner again visited duPont between July 16 and September 17, 1969 and computed net capital ratios, after adjustments, as 2,298 percent on June 30 and 2,181 percent on July 31. The capital ratios were actually much worse than indicated because no effect was given to unlocated short security differences, which were known to be material.

A public accounting firm made a computation of the firm's net capital position under NYSE rules as of September 28, 1969, (the date of the 1969 audit) and determined that the firm had a net capital deficiency of $6,827,000 and a ratio of 3,242 percent. The auditors noted in a footnote that their computation did not include any charges to capital for the valuation of unadjusted short security and stock differences totaling $8,759,845. A reserve of $4,600,000 had been added back into capital, so short stock differences had not even been charged to that extent.

The NYSE made its own computation of the firm's net capital as of the audit date which evidenced an even more serious situation. It determined that the firm had a net capital deficiency of $19,130,173. A subsequent recomputation reduced the net capital deficiency to $17,320,868.

On December 29, 1969, duPont reported to the NYSE that it had a net capital ratio of 1,950 percent as of December 24. The firm reported that the principal reason for the capital improvement was that it sold securities which it had on hand, but whose ownership could not be traced, and added the monies thus received to its capital.

In reply to a request, duPont supplied the following information to the Commission in regard to its net capital ratio as of the close of business January 15, 1970:

Net worth	$68,431,000
Net capital under NYSE rule 325	17,961,000
Aggregate indebtedness	322,044,000
Capital ratio (percent)	1,793

On January 21, 1970, a meeting was held at the NYSE concerning duPont's back office and financial problems. Although the meeting was principally between the NYSE and duPont officials, the Commission was invited as a spectator and was represented by officials from the New York Regional Office. The meeting concentrated on duPont's letter dated January 8, 1970 to the NYSE about duPont's plans to bring its capital ratio below 1,500 percent as soon as possible.

During the meeting four main problem areas were outlined by duPont as follows:

1. Non-current dividends—duPont had a target date of June 30, 1970 on the $17.4 million audit charge.
2. Fails over 90 days—duPont reported the $1.5 million penalty was down and presented no real problem.
3. Partly unsecured customer differences—duPont reported that by March 30, 1970, the figure of $8 million should be fully identified, i.e., correcting offsetting entries.
4. Security count differences—duPont reported that the long and short figures of $30 and $6 million would be identified as true longs and shorts as of March 31, 1970, or corrected and adjusted.

The firm stated it was raising $2 million, and duPont Laird was expected to place $10 million and provide a ceiling of $20 million capital at lower interest charges than other sources, which would be subordinated. Any call on duPont for withdrawal of capital would be locked in for one year, then six months, and was not to be withdrawn if it created a net capital deficit.

By January 15, 1970 duPont had a $2 million improvement in capital deficit from the audit date. Nevertheless, the net capital ratio had risen 95 points to 1,793 (from 1,698) because of market losses. It was anticipated that the firm would improve its capital because of a tax refund on a tax loss carryback. The tax refund was to be made after the books were closed on January 31, 1970 and the firm hoped to receive a payment from IRS sometime in May and a much larger amount in July 1970. All partners were required to reinvest their share of the tax refund they received.

The NYSE made a net capital computation, based on unaudited data submitted by duPont as of January 30, 1970, which showed a net capital ratio of 1,933 percent. An NYSE examiner noted, however, that short stock record differences of $9,902,748 were not deducted. If these differences had been deducted the capital ratio would have been 5,153 percent. duPont did not show any reserve whatsoever for such differences, so they were not even partially deducted as a charge against capital. The examiner indicated that duPont had no incentive to research old differences because it was not charging capital for them.

By January 31, 1970, duPont closed 17 offices (down to 94); fixed expenses had been reduced $1 million per month since July 1969 ($5 million instead of $6 million), and a new sales compensation rate was in effect saving $150,000 to $200,000 monthly. In addition, there was an increase in interest rates on margin accounts with a new formula based on activity and size, plus a penalty on bonds. Also, there had been no reductions in back office personnel except for cause, and losses in personnel were being replaced.

On March 13, 1970, the NYSE advised the Commission that it had taken disciplinary action against duPont and certain of its partners. duPont and three partners were censured, the firm was fined $50,000 and a senior partner, Edmund duPont, and the former managing partner and presently a limited partner, Charles Moran, Jr. were each fined $25,000. A former operations partner, Albert J. Coffee, was fined $10,000 but the fine was remitted because of his lack of employment since leaving duPont in June 1969.

The NYSE, based on unaudited data as of the end of May 1970 submitted by duPont, computed a net capital ratio of 1,989 percent. If the firm had charged its $9,654,000 of short stock record differences, net of a reserve of $500,000, the computation would have been 8,455 percent. The Commission noted that the firm had excess net capital of only $67,050 according to the NYSE, which allowed the firm credit for a mysterious item entitled "Other" in the amount of $314,859.

The NYSE approved the merger of duPont-Hirsch-Glore, Forgan effective July 1, 1970. On July 29, the NYSE briefed the Commission on 63 member firms having financial troubles. F. I. duPont, Glore, Forgan & Co. was among these firms. The NYSE stated that it considered duPont to be the number one problem firm. The Glore Forgan part of the merger did not strengthen the firm as much as had been expected; there were bookkeeping problems; and there was a significant reduction in capital because of a contribution to the duPont employees trust fund. Losses continued to be high; the estimated loss for July was $1.2 million. As of July 30, the firm's net capital ratio was 1,645 percent. Because the NYSE could foresee the possibility that the firm might end July with only a couple of million dollars in excess capital, it pressured the firm to raise additional money. The first step was to sell EDP machines and other fixed assets, for which it receives no capital credit, to Electronic Data Systems who was supposed to do duPont's EDP work for a fee and to make a subordinated loan of $2.8 million.

In September 1970 the NYSE required duPont to charge 50 percent of the excess of short stock record differences over long differences to capital. This charge was to be effective September 30, which was three days after the "as of" date for submitting its certified financial report to the NYSE and to the Commission.

On October 29, 1970, DTM submitted a memorandum to the Commission commenting on some significant problems concerning duPont including the treatment of these long and short stock record differences. DTM stated that stock record differences as of September 28, the audit date for 1970, after two weeks of researching and eliminations amounted to the following:

Long stock record differences	$20,630,000
Short stock record differences	33,132,000

It appeared that differences dating back to 1969 mounted to $2,830,000 long and $9,832,000 short. The reserve of $3,000,000 thus would prove inadequate to buy in even the old short differences. Also, it appeared that the firm was owed $5,234,000 in cash dividends and $5,595,000 in stock dividends which had been receivables for more than 30 days.

The auditors undertook reconcilement of 220 bank accounts and found 292 items where the firm showed lesser balances on its books than the banks record showed, totaling $4,378,357. On the other hand, they also found 690 items where the firm showed a greater balance on its books than the banks' records showed, totaling $13,064,553. Thus, the firm had net negative differences of $8.6 million. Many of the items dated back before September.

Unsecured accounts as of the last calculation by the auditors totaled $11.9 million, against which the firm had a reserve of $5.6 million. The amount of margin needed in the undermargined accounts totaled $7.8 million.

In November 1970, DTM conducted an inspection of the NYSE's early warning system and a further inspection of the NYSE's administration of its net capital rule for 10 to 20 firms. DTM submitted a long memorandum to the Commission and stated it had proposed to submit a series of memoranda over the next month. DTM stated that it was not furnishing any conclusions but the memoranda would allow the Commission to determine for itself the extent to which the NYSE knew of the problems of these firms and had acted to force corrective measures. Any conclusions drawn by the Commission were not in the files at the time of our review. Pertinent data in this memorandum has been previously inserted in the sequence of events for this firm.

On November 11, 1970, the NYSE informed the Commission that duPont lost about $550,000 in October, and that the firm had virtually exhausted all available internal sources for raising additional capital. An official of the NYSE stated the firm's net worth then was about $44 million and he was concerned because its aggregate indebtedness of some $332,000,000 was composed of sums largely owed to customers.

On January 23, 1971, DTM wrote another memorandum to the Commission on duPont. DTM stated that based on a letter of January 15 from the NYSE, duPont was facing another financial crisis. The firm had excess net capital of $12.7 million at the end of December and projected capital withdrawals during the first seven months of 1971 totaling $24.8 million. The firm had not made a capital computation since the end of November and would not make one until the end of January due to year-end adjustments having to be worked out. These adjustments included distribution of about $34 million in losses (including charges to capital and write-offs) to the partners.

DTM continued that on the basis of November 30, 1970 figures, the firm was reporting aggregate indebtedness of $263,327,000, net capital of $23,097,000, excess net capital of $9,930,000, and a ratio of 1,140. The excess capital was after a charge of $5 million against short stock record differences of $16.3 million. These differences remained from the September 1970 audit and did not include new differences because duPont had not counted its box since then.

In December, a good month for the industry, duPont lost $300,000 after netting a $600,000 profit by its underwriting subsidiary.

The NYSE, and the Commission to a lesser extent until the last half of 1970, were aware of the very serious financial and operational problems duPont was having and the firm's progress or lack thereof in overcoming them. The NYSE allowed this firm to remain in business

for more than two years while it knew duPont was in violation of the net capital rules on several occasions and could have been in violation on many other occasions under a different interpretation of the rules. For example, NYSE computed a net capital ratio as of the end of May 1970 of 1,989 percent, but noted that if short stock record differences of over $9.6 million had been included in the computation the ratio would have been 8.455 percent. duPont consistently had large short stock record differences. The Commission believes that these differences should be included in net capital computations but cannot require the NYSE to include them because it has exempted NYSE member firms from its net capital rules.

DuPont, being the second largest member firm of NYSE is another example where NYSE and the Commission were faced with a situation in which there were limitations on the actions which could be taken against the firm. The problem is how drastic can the actions be against a firm such as duPont that has had an aggregate indebtedness of as much as $332 million, most of which was owed to customers. The only action by the NYSE (documented in the Commission files), other than keeping a close watch on du Pont, was to place three restrictions on du Pont in October 1969 to prevent an increase in the volume of the firm's business. But the restrictions were removed three months later. The reason(s) why the restrictions were removed was not in the Commission's files. Apparently, NYSE did not require du Pont to reduce its volume of operations to a size its capital could properly support as was done with other member firms.

The Commission's actions during the period the firm was experiencing financial and operating difficulties would seem to be somewhat less than adequate or timely. It was aware of the large number of customer complaints (many customers sent the Commission a copy of their complaint) duPont was receiving for an extended period of time. It was also aware that duPont was in financial difficulty from time to time, but the files up until the fall of 1970 contain very little information on how severe the difficulty was or what periods of time were involved.

The Commission ordered a private proceedings against duPont on March 11, 1969, and hearings to be held on whether duPont's registration should be suspended. Hearings on this matter had not been held through June 30, 1970. The Commission stated it has been negotiating with duPont since March 1969 to settle this matter and thus avoid the need for hearings. It seems evident that the Commission never intended to decide whether duPont's registration should be suspended. Such an action would have closed the firm down, and the Commission was in no position to handle the effects of such an action, nor was NYSE.

It appeared that in October 1970 the NYSE relaxed a somewhat stern practice of disallowing the Commission access to certain pertinent files pertaining to its member firms. NYSE released numerous documents bearing on the financial and operational condition of duPont over the past two years. Previously the only information contained in the Commission files pertained to customer complaints and certain operation problems of du Pont.

As of the end of January 1971, it appears that the firm still has not resolved its financial difficulties and it remains to be seen what actions the NYSE will take and what the ultimate outcome will be for duPont.

Appendix B-14

ELLIS, STEWART & COMPANY, INC.

Ellis, Stewart & Company, Inc. (ESCO) became registered with the Commission April 6, 1968. The firm had an initial capitalization of $13,000. Significantly, the three officers reported that they had had no connection with or financial interest in any broker or dealer within at least the past 10 years. ESCO was a member of the National Association of Securities Dealers but was not a member of a national stock exchange. It had one office located in Los Angeles.

On February 28, 1969, (approximately 11 months after inception) ESCO filed a voluntary petition in bankruptcy. While the outcome of the bankruptcy hearing was still pending. ESCO's president/director applied for registration as a broker-dealer on August 8, 1969 to do buisiness as Key Industries in Los Angeles. The Commission permitted the registration as a broker-dealer to become effetive November 26, 1969.

An analysis of ESCO's financial report dated September 30, 1968 by the Commission showed adjusted net capital of $22,029 compared to a capital requirement of $50,428. Ellis stated this was a result of fails to receive totaling $955,366, consisting of mutual fund transactions which were either cancelled or settled within a few days after the September report. ESCO was placed under capital surveillance for three months.

The trial balance at December 31, 1968 showed adjusted net capital of $9,950 against a required capital of $9,682. The ESCO trial balance as of January 31, 1969 showed adjusted net capital of $11,000 against a capital requirement of $14,323. (The Commission examined the statement on February 20.) Ellis deposited $10,000 in ESCO's bank account to comply with the net capital rule. During a Comission examination of the books on February 25, Ellis stated he wanted to cease operations because several investors had failed to make payment for in excess of 4,000 shares of one stock. The stock had an approximate cost of $140,-000 and on February 25, it had a substantially less but undetermined value.

The examination of the ledger sheets disclosed that 1,100 shares of stock purchased December 31, 1968 for $48,750 and 3,000 shares of the same stock purchased January 29, 1969, for $90,000 had not been paid for. These purchases had been cancelled, according to Ellis, but the cancellations had not been recorded. The examination also noted that the financial statement dated January 31, 1969 was false in that it showed the $48,750 purchase as a good receivable.

The examination also showed that on January 29, 1969, the Ellis account reflected purchases of 2,000 shares of two stocks, for $18,984. Prior to such purchase, the account reflected a credit balance of $2,154 which would not have been sufficient to satisfy the margin requirements of Regulation T.

Additionally, the Commission examination also disclosed that on numerous occasions in January and February 1969 Ellis effected transactions with customers and broker-dealers while insolvent and unable to meet its current obligations.

The Commission also determined that: ESCO failed to install and keep current a daily blotter; failed to accurately maintain customer

ledger accounts; and failed to maintain ledgers reflecting security transfer, dividends and interest received, bank loans, and securities failed to receive and failed to deliver.

On April 17, 1969, ESCO filed a plan of arrangement with the District Court in connection with its bankruptcy proceeding. The plan showed ESCO had liabilities of $277,370 and assets estimated at $192,-550. Under the plan ESCO proposed to pay in full, in cash, all of the expenses of the bankruptcy proceeding, and any and all priority claims upon confirmation of the plan.

ESCO further proposed to pay the general unsecured creditors in full ($60,988). These sums would be paid from the net profits of the business, as determined at regular intervals by appropriate accountings. The president of ESCO would retain only the brokerage commissions as salary during the period of the plan.

On May 8, a trial attorney for the Commission's San Francisco Regional Office wrote to the referee in bankruptcy concerning ESCO's proposed plan of arrangement. The attorney stated that ESCO had failed to meet the Commission's record-keeping rules during the period from April 6, 1968 through February 25, 1969, had violated the margin and net capital requirements during December 1968 and January and February 1969, and had engaged in the securities business while insolvent in February 1969. The attorney stated further that manifestly no provisions for creditors should be predicated on an operation of a business in violation of law, and pointed out to the Court that ESCO would be expected to comply with the Federal securities laws and the Commission's rule when it re-engaged in the securities business as proposed in the plan of arrangement. The information was submitted to the referee because the attorney believed it would be of interest to the Court and the creditors in this arrangement proceeding, especially in view of the proposed plan of arrangement whereby the general unsecured creditors would be paid in full "from the net profits of the business."

On May 12, 1969, an investigator from the Los Angeles Branch Office attended a meeting of creditors of ESCO and the referee in bankruptcy. ESCO's attorney informed the referee that the list of creditors submitted by ESCO was incomplete; that ESCO had furnished him with additional names of creditors; and that an amendment to the plan of arrangement would be filed. The referee stated that the previously filed plan would be dismissed and ESCO would not be permitted to file an amendment thereto. He stated that the Commission should complete its investigation of ESCO and file its report with the bankruptcy court before a new plan of arrangement was filed. If the investigation took too long, the objections raised in the Commission attorney's letter of May 8 must still overcome.

Officials of the Los Angeles Branch Office informed us on July 30, 1970, that ESCO was still in bankruptcy proceedings. It is estimated that a loss of $85,000 will be incurred by other broker-dealers but there will be no customer losses.

Formation of a new firm by ESCO's president

On August 8, 1969, Stephen B. Ellis applied for registration as a broker-dealer to do business as Key Industries, a sole proprietorship. Ellis commented in his application that as of that date no action had

been taken or implied against him by any of the regulatory agencies. Key Industries' registration with SEC became effective on November 26, 1969. The stated function of the firm was to solicit funds from persons in connection with the sales of certificates of deposits by banks.

On October 27, 1969, Ellis filed with the Commission a statement of financial condition of Key Industries reflecting cash in banks and on hand of $8,500. In March or April 1970, a check by the Commission with the bank indicated that Key Industries opened an account with a deposit of $100 on December 17, 1969; that another company, Ellis Stewart & Company of California had a balance of $8,013.10 as of October 31, 1969. Further, the Commission stated that the statement of financial condition listed numerous items of personal property of questionable value, particularly at the valuation listed by Ellis. These include art objects ($5,000 market value), personal jewelry and furniture ($19,500 at market value), a coin and stamp collection ($10,750 at catalog value.)

On the check sheet for the examination of the financial statement for 1970, the capital condition of Key Industries indicated a deficit of $4,350. Also, under the comments section, a hand-written note showed that the April 30, 1970 statement of financial condition reported $5,-538 in the bank. However, an inquiry by the Commission at the bank disclosed that the balance of the account was $50 (the Key Industries statement was not certified by an accountant.)

The Assistant Regional Administrator, Los Angeles Branch Office, informed us on July 30, 1970 that the registration of Key Industries should not have been allowed to go into effect. He explained that when the Washington, D.C. office received the application of registration, it sent out the normal record search form to the San Francisco Branch Office. Registration automatically becomes effective in 30 days unless the form is returned showing reasons for disapproving the application or if the form is not returned within 30 days of the filing of the application. In this case, the records search form did not reach the Branch Office until after the 30 day time period. He stated that the registrations of both ESCO and Key Industries were in process of being revoked.

Appendix B–15

FIDLER SECURITIES CORPORATION

Fidler Securities Corporation, a Delaware corporation, became a registered broker-dealer with the Commission on November 27, 1969. Fidler was a member of the National Association of Securities Dealers, but was not a member of a stock exchange. It had one office located in Beverly Hills, California. The firm was initially capitalized with nine subordinated notes totaling $250,000. Subsequently there was an additional $251,000 paid in as capital as shown on a financial statement as of June 24, 1970.

Fidler notified the Commission by letter dated June 23, 1970 (seven months after inception) that it was unable to meet its current obligations, and as a consequence ceased to conduct a securities business on that date. Fidler stated that it had outstanding checks which it could not honor (amount not indicated). The firm further stated that this situation arose primarily from the fact that lending arrangements

with local banks were unilaterally rescinded by the banks. This explanation, however, is not completely accurate as it appears that the primary reason for the financial difficulties was due to a severe market decline in a period of one week in certain speculative issues.

Fidler's rapid decline can be seen when it is noted that as of April 24 it had an adjusted net capital of $49,350 which was $20,816 in excess of the Commission's requirements. However, on May 29, a computation of the ratio of aggregate indebtedness to liquid net capital showed a need of additional capital of $11,695 and on June 24 there was a need of additional capital of $5,406. Moreover, as of May 29, there was a cumulative deficit for the six months of operations amounting to $271,548 and as of June 24 the cumulative deficit was $515,147. It was during this period that the severe market decline in Fidler-held securities occurred. Also during this period, Fidler apparently again invested heavily in speculative issues. It is noted that as of May 29 Fidler's inventory of firm-owned securities amounted to only $115,000 long and $60,000 short. The deficit incurred during this period was greater than the entire inventory.

It was further noted that as of June 24 Fidler owed $316,741 to brokers and $65,949 to customers. The total liabilities (including the amounts due to brokers and customers) was $556,000 as opposed to assets amounting to $551,000. Assuming that the valuation of assets and liabilities proves to be accurate during liquidation, it would appear that customer losses, if any, will not be too great.

The SEC took no action against Fidler because the firm voluntarily filed a petition for arrangement under Chapter XI of the National Bankruptcy Act on June 26.

This firm was in operation only seven months. This is another case typifying the problems that can be encountered in a relatively short period of time resulting in incurring considerable losses. In this case the loss to customers will probably be relatively small. This was apparently due to the fact that the firm maintained current records and management did not engage in improper evasive action—a practice not uncommon.

Moreover, this case typifies the concern that should be given to the practice of including speculative firm-owned and/or borrowed stocks as capital.

Appendix B–16

FIRST SECURITIES COMPANY OF CHICAGO, INC.

The registrant, a corporation chartered in Illinois on March 25, 1939, began business under the name of George F. Ryan Co. Its name was changed to Ryan Nichols & Co. March 31, 1941 and its present name was adopted June 24, 1944.

The firm was located in Chicago, and had a branch office in Champaign, Illinois. The firm was a member of the Midwest Stock Exchange and the NASD.

On June 4, 1968, Lestor B. Nay, president of the firm killed his wife, then committed suicide. Prior to committing suicide, Nay prepared a note admitting embezzling certain securities. In this note, he said that the company was bankrupt because of his thefts. Although the

date of his becoming president is not known, he was president, treasurer and director from at least February 1946 to his death. At the time of his death, Nay was 90 percent owner of the firm.

Prior to Nay's death company records had indicated the firm to be in good financial condition. A financial report as of October 31, 1967 showed that assets substantially exceeded liabilities; and a trial balance prepared May 31, 1968 confirmed this, showing $597,776 in assets and $438,052 in liabilities.

The true financial situation of the firm apparently was not known and on June 7, 1968, SEC's Chicago Regional Office (CRO), as a result of its preliminary inquiry, requested authority to file an injunctive action against the firm. This action was approved by the Commission on June 10 and a complaint was filed on the same date. SEC alleged that the firm was doing business without disclosing that its liabilities exceeded its assets and that it was unable to meet its liabilities as they matured. The court entered an order restraining the disposition of the firm's assets on June 12. On June 13 the court issued a preliminary injunction enjoining the firm from violating Section 17(a) of the Securities Act of 1933, and Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. The order was consented to by the firm. A receiver of the firm's assets was appointed on June 17 and on June 20 a Special Master was appointed to hear special matters regarding the firm.

SEC files show that as of September 30, 1968, claims against the firm totaled $2,713,550.00, not including claims for the delivery of securities in the possession of the receiver. As of that date, available funds were estimated to be $812,615 and estimated in June 1970 to be about $1,000,000. It was believed that additional funds may become available by reason of a claim under a fidelity bond ($100,000) and by a contribution from the Midwest Stock Exchange (amount to be contributed not known).

Of the $2,713,550 claimed, $1,955,000 represents claims for which no information was available in the books of account of the company, and appears to be the result of Nay's embezzlement. $975,000 of the $1,955,000 represents claims by parties who invested in a "spurious escrow account" touted by Nay. The admissibility of these escrow claims against the firm has not yet been decided.

The reason for the insolvency of the firm appears to be due solely to the embezzlements and other illegal activties of the firm's president, Lestor B. Nay. Nay's note indicates that the defalcations began as early as 1938.

The firm's problems were discovered when the president committed suicide. It does not appear that this problem would be readily ascertainable from documents or reports normally submitted by the firm. The last record of an inspection of the firm by SEC was as of March 24, 1965. However, embezzlements can be extremely difficult to detect and it is doubtful that it would be detected through a normal SEC inspection.

Based upon the information available in SEC files, the Midwest Stock Exchange had little to do in any investigative proceedings. However, it did say that its special trust fund would be available to mitigate or prevent losses to public securities customers. The trust

fund will not be available to mitigate or prevent losses to escrow claimants.

Disposition of claims has been a lengthy process, and in the two years since the appointment of a receiver, no claims have been paid except those of the receiver and the Special Master. Securities held by the firm for safekeeping have been returned to customers. The lengthy disposition and non-payment to the date of our review in June 1970 appear at least partly due to the following factors:

1. the complexity of and legal questions regarding the claims; and
2. MSE procedure which calls for adjudication of all claims before making any decisions regarding contributions from its special trust fund.

Due to the magnitude of unresolved claims still pending, an estimate of assistance necessary to complete liquidation is not possible.

Appendix B–17

FRANK D. FORD CO.

Mr. Harm H. Schlomer, Jr. was a sole proprietor engaged in a general securities business (primarily trading in mining stock) under the name of Frank D. Ford Co., Spokane, Washington. Schlomer became a registered broker-dealer with SEC May 14, 1969, and a member of the Spokane Stock Exchange on May 26, 1969; he was not a member of the National Association of Securities Dealers. He was the firm's only salesman and there were four other employees.

Schlomer was qualified to become a registered broker-dealer under present criteria. However, his particular background should be noted. He was 32 years old. He received a college degree in 1964 following two years in the Army. His education was in literature and the languages, with a major in German literature and a minor in political science. His business background consisted of employment with the brokerage firm of West Coast Brokerage & Investment Company as an underwriter from 1961 to 1965 and as a stock trader (firm unknown) from 1965 through 1968, trading stocks for his own account.

The firm was qualified financially, but again its original condition should be noted. Schlomer's balance sheet submitted as of May 1, 1969 in conjunction with his registration, showed assets of $116,565 and liabilities of $30,800. The bulk of the assets consisted of mining stocks valued from $0.22 to $6.75 a share. The assets also included such items as a coin collection, an automobile, real estate and other personal property. Cash amounted to only $5,000, the minimum liquidity requirement.

The Commission conducted an inspection of the firm on September 22, 1969, approximately four months after inception. The inspection revealed four major violations of regulations; namely, net capital, bookkeeping, Regulation T, and failure to inform customers that their free credit balances were not segregated and might be used in the firm's operation. With regard to the net capital deficiency, although Schlomer reported a substantial capital surplus over the requirement, the inspection revealed that the firm's trading inventory had not been adjusted to market value and liabilities had not been deducted. As a

consequence, a corrected capital computation revealed a deficiency at the close of each month since inception ranging from $22,000 to $46,-000. These are substantial deficiencies considering the meager original capitalization. Nevertheless, the Commission did not require Schlomer to cease operations, but rather merely requested a monthly trial balance until further notice.

Schlomer voluntarily ceased operations on October 29 as a result of being suspended from the Spokane Stock Exchange two days previously because of an inability to meet obligations. The State of Washington suspended Schlomer's registration with the State on November 7 and he commenced liquidating the business.

The Commission maintained a surveillance of the firm after the original inspection and initiated a formal investigation on November 12. This investigation revealed that during the period of the substantial capital deficiencies, mentioned above, the mails and facilities of interstate commerce were used on numerous occasions to conduct the securities business in contravention of regulations. Also, from a time prior to August 29 and continuing to about October 30, Schlomer issued checks to customers and other creditors totaling approximately $28,000 drawn against bank accounts having insufficient funds. In addition, payments of personal debts amounting to $11,135 were reflected in the books and records as loans of securities rather than as withdrawals of capital.

The Commission did not request the appointment of a receiver because there was no danger to the interests of the investing public as it did not appear that the customers would incur any losses.

On April 2, 1970, SEC released their findings and remedial sanctions against Schlomer. His broker-dealer registration was revoked, and he was expelled from the Spokane Stock Exchange. Also, he was barred from association with any broker or dealer for a period of one year, after which he could become associated with a broker or dealer under such supervision as the Commission deemed appropriate.

The cause of the firm's failure was not identified by the Commission. However, with Schlomer's weak financial position at inception, coupled with the fact that he and his office personnel had very limited experience in the operations of a brokerage firm, it would be logical to conclude that these factors contributed substantially to the insolvency of the firm.

The submittal of a balance sheet by an applicant serves the purpose of informing the Commission that its minimum requirements have been met. The only occasion the Commission acts on the statement is when the applicant fails to meet the requirement. Rarely will the Commission inform the applicant of a weak financial condition. In the case at hand, although only the minimum requirements were satisfied, Schlomer probably was under the impression that he was financially sound and conducted a volume of business incompatible to capital. Because of the firm's employees' apparent inexperience and unfamiliarity with the Commission's rules and regulations, it was believed there was a substantial excess of capital whereas the Commission determined that the firm needed $22,000 as of May 31, 1969, less than a month after becoming registered, and needed additional capital every month thereafter. Therefore, in no time the business turned towards insolvency.

Appendix B-18

GARDNER SECURITIES CORPORATION

Gardner Securities Corporation became registered with the Commission as a broker-dealer on March 12, 1969. It was a member of the National Association of Securities Dealers but was not a member of an exchange. Michael S. Gardner was president, sole director, and sole stockholder.

Gardner had initial capital of $50,000, but within six months had a net capital deficiency of almost $195,000 based on a trial balance as of September 16, 1969, submitted at the request of NASD. Gardner agreed to conduct only liquidating transactions until the NASD certified that the firm was again in compliance with the net capital rules. The NASD later notified the Commission that Gardner did not honor the agreement.

The Commission, therefore, conducted an inspection. This inspection confirmed that Gardner had violated the net capital rules and also disclosed that its books and records were in such condition that it was impossible to accurately determine the firm's net capital.

In addition, a serious violation of an underwriting agreement was noted. The underwriting involved 100,000 shares of stock at $3.00 a share—on an all or none, best efforts basis. All shares were to be sold by December 16, 1969 or all money received by Gardner was to be returned to the purchasers; in the interim, the proceeds were to be deposited in a special bank account. As of December 4, Gardner had sold 13,000 shares but the account had a balance of only $4,456—far short of the $39,000 that should have been in the account.

Based on the Commission's complaint alleging the findings of its investigation the court issued a permanent injunction on December 16, 1969, enjoining Gardner and its president from further violations of the anti-fraud, net capital, bookkeeping and financial reporting provisions of the Securities Exchange Act of 1934. The court also appointed a receiver of the assets of Gardner.

The firm had 1,000 public customers when it went into receivership and it is estimated they will incur losses of approximately $200,000. It is also estimated that other broker-dealers will incur losses amounting to $50,000.

This case typifies the fact that small firms, even with capital considerably in excess of the minimum required, can incur sizeable losses in a relatively short period of time. In this instance the files did not document the cause(s) of the financial difficulties. In view of the fact that only six months elapsed between inception of the firm and the detection of its violation of the net capital rule it is questionable whether the regulatory bodies could reasonably have been expected to have detected the difficulties sooner. Nevertheless, it would appear that the causes for the difficulties would be well documented on an after the fact basis so that an effort could be made to prevent the same tragedy from happening to another firm. No effort seems to be being made to change rules, procedures, or legislation designed to prevent failure. Prevention of failure of broker-dealers is the greatest protection for customers because they are afforded full use of their investment and not just an ultimate refund.

Appendix B–19

GEMMA SECURITIES, INC.

Gemma Securities, Inc. became registered with the Commission as a broker-dealer on February 4, 1965. It had one office located in Worcester, Massachusetts. Gemma was a member of the National Association of Securities Dealers but was not a member of a stock exchange. SEC stated that Gemma did a general securities business, primarily involved in mutual funds, in making markets in unlisted securities, and in some underwriting.

The Division of Trading and Markets (DTM) stated that on September 30, 1968, NASD made a routine inspection of Gemma and found that the stock record was posted only through June 1968 and that the trial balances for May, June and July had errors in the customer and broker accounts. These errors prevented Gemma from furnishing the NASD a computation of its net capital, however, the NASD was satisfied that the net capital position of Gemma was satisfactory during that period. The NASD notified Gemma that a follow-up inspection would take place in 60 days and the firm was to clear up the bookkeeping violations and other minor items by that time.

The NASD did not make the follow-up inspection until January 20, 1969 rather than November 30, 1968. The inspection revealed that the customers' and brokers' ledgers were not posted for December and a capital deficiency of $6,000. On January 27, Gemma informed the NASD that it was ceasing wholesale operations, which comprised 75 percent of the firm's volume, until it remedied its back-office problems. DTM stated that this restriction was self-imposed by Gemma without the prior knowledge of the NASD or the SEC.

On March 29, 1969, the certified public accountant engaged by Gemma to audit the books and records and to prepare the financial report as of December 31, 1968, wrote to the SEC Boston Regional Office citing certain changes Gemma had made in its accounting and recordkeeping operations on December 1. The accountant stated that the changes had been made in view of the warnings by the NASD to correct the firm's back-office problems. He stated that effective March 1, 1969 the firm computerized its operations in order to do a better job. The accountant stated further that he had recommended that Gemma deliver all customers' securities to the customers, including all safe-keeping securities, and the firm had acquiesced.

Gemma filed it financial report, due February 14, 1969, with SEC on April 1, after SEC had granted the firm two extensions of time for filing. Analysis of the report by SEC revealed a net capital violation as of December 31, 1968; about $6,400 of additional capital was required. Gemma in response to an inquiry from the Boston Regional Office on the violation stated that in the meantime it had liquidated some of its securities in order to bring itself in compliance with the SEC net capital rule. The Regional Office sent a copy of Gemma's financial report to the NASD in the second week of April.

On April 22, the NASD issued a complaint against Gemma, alleging the firm had violated the rules for books and records in September and December 1968 and the net capital rule in December 1968. Gemma's answer to the complaint admitted to all the material facts. Subsequently,

the Regional Office informed the NASD that Gemma had violated the net capital rules in May and June 1969 and the NASD amended its complaint to include these violations. A hearing scheduled for July 9 by the NASD had to be postponed to allow Gemma time to answer the amended complaint. The hearing was then not immediately rescheduled by the NASD because Gemma had promised the Regional Office a trial balance for July by August 5, and the NASD wanted the results of this trial balance before holding the hearing.

On June 19, 1969, the Boston Regional Office made an inspection of Gemma for the 12 months ended that date. The Regional Office computed the firm's net capital and determined that an additional $18,617 of capital was needed for Gemma to be in compliance with the net capital rule. The inspection report showed that the last previous inspection of Gemma by SEC was for the 6 months ended June 30, 1967. On July 15, 1969, the Regional Office wrote to Gemma and requested that it take immediate steps to correct this net capital violation and to submit a trial balance as promptly as possible which would reflect the corrective steps taken.

On July 28, the Regional Office received an undated letter from Gemma stating that the firm had ceased operations as of July 22, due to a capital deficiency but that by July 25, it was able to resume operations after adding $14,300 of subordinated capital. On August 3, Gemma requested a hearing with the NASD to attempt to seek a solution to the firm's problems. The matters discussed at the hearing were not in the SEC files.

The Regional Office and the NASD were unable to obtain a July trial balance promised by Gemma by August 5, and the NASD scheduled a hearing on its complaint for September 4. At that hearing the president of the firm told the NASD that he might be insolvent. The NASD notified the Regional Office of this and the Regional Office inspected the firm on September 5 and 8.

The Regional Office found that Gemma was 10–14 days late in posting to the required daily blotters (journals) the customers' ledgers, the brokers' ledgers, and the general ledger. In addition, information derived from the firm's accountant and bookkeeper indicated that all ledgers and records contained many inaccuracies. A check of the customers' accounts September 6 and 7 revealed that in 500 accounts there were that many errors. The most recent trial balance available was as of July 31, and the Regional Office's computation of the firm's net capital showed a deficiency of $17,315 as of that date. Evidence obtained during the inspection indicated that Gemma continued to do business until August 27, and effected over 170 transactions while in violation of the Commission's net capital rules. There was no evidence of transactions subsequent to August 27.

On September 5, the president of Gemma indicated to an investigator of the Regional Office that on or about August 11 at least six customers had demanded their free credit balances amounting to about $22,125, but he told them he was unable to pay them. The president indicated that currently he owed $60,000 to customers. He also told the investigator on September 9 that ten or eleven of his checks, one of which was drawn on August 22, to customers and brokers amounting to a total of about $15,000 had been returned because of insufficient funds.

On September 11, the Commission authorized the filing of a complaint seeking to enjoin Gemma and its president from further violations of the record-keeping and net capital rules and seeking the appointment of a receiver for the firm. The Regional Office filed the complaint on September 12 and the U.S. District Court granted a temporary restraining order on September 15. The court also granted the Commission's request for a preliminary injunction and the appointment of a receiver on October 14, 1969.

DTM stated on September 26, 1969 that the NASD was going to its governing body the week of September 15 and seek expulsion of Gemma from the NASD) based on its amended complaint of April 22.

In an investigation progress report for the quarter ending December 31, 1969, the Regional Office reported it had been assisting the receiver in his efforts to reconcile various claims against Gemma. In a report for the quarter ending March 31, 1970, the Regional Office reported it had been assisting the receiver and that it had made several appearances before the court in connection with the receivership. The Regional Office stated that it would appear that Gemma would consent to a final decree and that administrative action would be undertaken. In a report for the quarter ending June 30, the Regional Office reported that the receivership was being continued with liaison between its staff and the receiver, and that administrative proceedings might be undertaken in the next quarter.

As of July 14, 1970, receivership action was still in process. A final order and further action were contingent on the results of receivership. It is estimated that customer losses will amount to $125,000 and other broker-dealers' losses will amount to $28,000.

Appendix B–20

GOODRICH INVESTMENT CORPORATION

The Goodrich Investment Corporation became registered with the Commission as a broker-dealer December 28, 1967. The Commission stated that the three principal officers (president, vice-president and secretary, vice-president and treasurer) with the exception of sales work performed for other broker-dealers were inexperienced respecting security matters. The firm was a member of the NASD but was not a member of a stock exchange.

The Commission reported that it was informed of the problems of Goodrich by the firm itself. The Los Angeles Branch Office (LABO) stated that the firm's difficulties stemmed entirely from a series of orders placed by a customer during the period from June 13 to July 15, 1968, for a total of about 32,900 shares of Amco Corporation for about $347,000. LABO stated that Amco was listed on the American Stock Exchange and that Goodrich, without any inquiry as to the reason for ordering a listed stock through a small over-the-counter dealer and without adequate inquiry as to the customer's ability to pay, bought the stock for the account of the customer as ordered. The price of the stock declined and the customer refused to pay for the stock. The firm of Kleiner-Bell & Co., who purchased the stock for Goodrich, sold the stock at a loss of $56,889.

The firm continued to engage in a brokerage business until August 28, 1968. The Commission reported that during the months of July and

August 1968, officers of the firm drew advances totaling $2,400 although the firm had incurred a large loss through the customer's refusal to pay for the stock.

After being informed by the firm of its financial problems, the San Francisco Regional Office recommended to the Division of Trading and Markets on September 5 that it be given standby authority to file a complaint based upon violations of the net capital rule, doing business while insolvent, and failure to keep current books and records. There was no information in the files to show whether this authority was approved by the Commission. However, this authority was not needed because Goodrich filed a petition pursuant to Chapter XI of the Bankruptcy Act on October 16, 1968. A referee in bankruptcy and a receiver for the firm were appointed on October 28.

Computations by the Commission and the NASD of Goodrich's net capital disclosed that the firm was $1,142 and $397 above the Commission's minimum requirement as of April 8 and July 31, 1968 respectively. Therefore, the loss of about $57,000 by Goodrich due to one customer immediately caused the firm to be in violation of the net capital rules. The drawing of advances by the firm's officers in July and August 1968 caused the firm's capital to be depleted further.

There was a 41 day lapse between the date of the San Francisco Regional Office recommendations and the date when Goodrich filed for bankruptcy. There is no information in the SEC files of what transpired during this period. In our opinion, the Commission's actions did not appear timely.

An accounting firm was employed at the direction of the court, to perform an independent audit of the company's books as of October 16, 1968. The purpose of the audit was to verify the various assets and liabilities appearing on the books of the firm as of October 16 in order that the financial position of the firm and equities in the various security accounts might be determined. The auditors stated that from January 3 to October 16, the firm incurred a net loss on a going concern basis of $80,594.

On January 28, 1969, the firm filed a Plan of Arrangement with its unsecured creditors at the U.S. District Court. The Plan provided for:

1. The collection of all accounts receivable.
2. Payment of balance due Kleiner-Bell & Co. and release to Goodrich of securities held by Kleiner-Bell & Co.
3. Delivery to customers of all securities long, with the exception of Trihope Resources shares. Customers who purchased Trihope shares will receive approximately 85 percent of the shares due them as Goodrich will be short approximately 2,700 shares of Trihope. The shortage of Trihope shares will be prorated among the Trihope purchasers who have agreed to assume the liability for the Interest Equalization Tax involved.
4. Cash disbursements as follows:
   (*a*) Customers having free credit balance, will receive 75 percent of the amount due them.
   (*b*) Other creditors will receive 25 percent of the amount of their claims.

5. Certain lawsuits instituted by James Dizon and Peter Polland will be assigned in trust for the benefit of Goodrich customers, thus increasing the amount to be received by customers with free credit balances and the Trihope customers if the suits are successful.

This Plan was to eliminate a straight bankruptcy proceeding in which all assets would be thrown into one pot and the securities allocated by the receiver. We were informed on July 30, 1970 that Goodrich was still making settlement with creditors. It is estimated that customer losses will amount to $69,500 and losses to other broker-dealers will be $56,000.

Meanwhile, on August 31, 1969, the L. J. Berman & Co., Inc. filed an amendment to the registration of Goodrich as a broker-dealer with the Commission. This amendment was filed to transfer the registration of the Goodrich Investment Corporation to L. J. Berman & Co., Inc.[1] An adjustment to the amendment was filed on October 1, 1969. The L. J. Berman Co., Inc. listed the following individuals as officers and directors:

Loren J. Berman, president;
Peter D. Polland, vice-president; and
Frank J. Steiner, secretary.

Mr. Berman was a securities salesman with H. Hentz & Co. and Bache & Co. He was self-employed in the investment field starting in March 1969. Mr. Polland was a former vice-president and secretary of Goodrich Investment Corporation and was self-employed in mergers, acquisitions and investments starting in September 1968. Mr. Steiner was self-employed in the investment field starting in 1964 after owning a salvage business.

The balance sheet of the firm on August 25, 1969 listed total capital of $45,000, consisting primarily of a demand note receivable of $40,000 from Loren J. Berman.

On March 25, 1970, the Commission informed the firm that it failed to file a report of financial condition as of a date within 1969 as required by paragraph (9) of rule 17a-5. Officials of the Commission informed us in August 1970 that Berman had not conducted any business since its registration became effective. They stated also that the president of the firm was suspected of violations of the anti-fraud provisions of the Federal securities laws in the manipulation and improper sales of stocks involving substantial sums of money. The Commission was planning to revoke the firm's registration.

Appendix B-21

GOSS, REHART & CO., INC.

Goss, Rehart & Co., Incorporated became a registered broker-dealer with the Commission on January 22, 1969. Goss was a member of the National Association of Securities Dealers and the Pacific Coast Stock Exchange (PCSE). Goss did a trading business, both over-the-counter and on the Exchange. It had about 300 customers and seven employees in its office located in Los Angeles, California.

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[1] Officials of the Commission's Division of Trading and Markets did not know why Berman took this course of action instead of filing a new original application for registration in its own name.

Goss had an initial capitalization of $200,000, well above the $5,000 minimum requirement.

The Commission inspected the firm on October 21, 1969, nine months after it became registered, and found no violations of the rules and regulations. However, in the months following Goss began experiencing financial difficulties as a result of operating losses and declining market values of stock. As a consequence, NASD found that as of April 24, 1970, based on PCSE capital requirements, Goss needed additional capital in the amount of $68,121. This situation was aggravated when Goss purchased AT&T warrants on a "when issued" basis valued at $850,000. Goss collected full payment from its customers (an investment advisory firm and a bank) on May 8. However, Goss used about half of the receipts to pay off bank loans and consequently was short by about $400,000 on June 8 when settlement for the warrants was due.

A further aggravation was the fact that during the period from about May 1 to June 8 firm-owned and subordinated securities dropped in value from $1,093,656 to $542,000.

Goss informed PCSE of its difficulties on May 15. Also on this date, it ceased trading in over-the-counter securities. One week later Goss ceased all brokerage activity.

The Commission's Los Angeles Branch Office inspected the firm on June 8 and found, in addition to the insolvency mentioned above, that based on PCSE capital requirements, additional capital of $545,099 was needed. Consequently, on the following day PCSE suspended Goss from its membership. Also on this day, the Branch Office informed Goss and PCSE that under the circumstances there was no alternative but to recommend to the Commission that injunctive action be instituted, based upon the firm doing business while insolvent, which is a violation of Rule 10b-5.

The Commission approved this course of action on June 11 and the next day the U.S. District Court entered a final judgment permanently enjoining Goss from violating section 10(b) of the Securities Exchange Act of 1934. The Court appointed the Pacific Coast Stock Clearing Corporation, a wholly-owned subsidiary of the PCSE, as receiver of the firm.

PCSE anticipates that the firm will go into bankruptcy but in June 1970 an estimate could not be given as to the amount, if any, of customer losses.

This was a relatively small firm which was in business for only a little over a year. Its demise was caused by rapid declining market values in its security inventory and subordinated securities. When this occurred the firm engaged in improper business practices which added to its financial difficulties. This case illustrates the necessity for restricting capital in the form of securities.

Appendix B-22

M. L. GRAHAM & CO.

M. L. Graham & Co. became registered with the Commission as a broker-dealer on October 20, 1968. The firm was a member of NASD

but not a member of any exchange. Liquidation procedures were commenced after an investigation initiated on March 17, 1969 (after less than five months of operations) revealed several violations of the Commission rules and regulations. The violations included the net capital rule, books and records were not properly maintained, customers securities were over-hypothecated, and a subordinated loan agreement filed with the Commission was not consummated. A receiver was appointed by the court. The receiver's report indicates, among other things, that 27 customers stand to lose securities valued at $110,000.

A financial statement was filed and dated October 15, 1968 (five days prior to the application approval). The statement was filed by an accountant without independent verification; it indicated total assets of $30,000 and liabilities of $25,000. The assets consisted of $5,000 cash and an account receivable of $25,000. The account receivable was a contra to the liability which was a personal loan from Graham to the company.

The Commission made an attempt to verify pertinent data in Graham's application. For example, the University from which Graham graduated was requested to confirm the existence of Graham's degree. Moreover, the SEC attorney in charge of registration and litigation at the Commission's San Francisco Regional Office interviewed the applicant on two occasions, interviewed one former employer, corresponded with another former employer, and had a review made of Commission records.

The review of Commission records revealed that—

> Although it appears that Graham may have violated provisions of the Securities Act in connection with an unregistered distribution of Trihope Shores, the San Francisco Regional Office does not now possess sufficient information to recommend institution of denial proceedings in connection with this application.

Graham's former employer from October 6, 1966 to February 29, 1968, responding to a Commission inquiry confirmed that Graham was dismissed and that he took security positions with three stocks without permission. Subsequent to his dismissal it was determined he took seven securities into principal position and placed them in customers' accounts. None of these securities were recommended by the firm and records do not indicate that these positions were maintained overnight. In addition, it was stated that problems were created in at least five customer accounts:

> While these problems were varied, they might be generally categorized as having ambiguous delivery vs. payment instructions.

Interestingly, one of the accounts listed was for Mrs. Thelma Kraus, who is also listed as a director of Graham & Co. Another account was listed for Mr. Russel Kraus, but the relationship to Thelma Kraus, if any, was not indicated.

An interview was conducted on October 11, 1968 with the sales manager of the former employer of Graham from March through August, 1968 (per his application—interview states employment was from April through July 31.) The interview memo states:

> . . . (sales manager) stated that Graham had resigned after being requested to leave and that the firm had furnished a letter to the New York Stock Exchange, detailing five reasons why.

These reasons were listed as:

1. repeatedly sold securities which were not readily available for delivery.
2. repeatedly opened margin accounts without promptly securing signed margin agreements.
3. engaged in highly speculative personal investing with heavy leverage, in the course of which he sold stock to clients in which he had previously taken a position for his own account.
4. engaged in the promotion of a speculative Canadian issue away from our office and without our knowledge and approval.
5. called on brokers and corporate officers in the course of making personal research investigations contrary to our policy and instructions.

The interview memo elaborates on these reasons and states:

> Graham was relieved of his position not because he had violated any NASD or SEC regulations, but because Graham's general type of business was "not up our alley": . . . the customers he brought to [us] would repeatedly sell securities which they could not deliver and which became fails to deliver on [our] books; that Graham's attitude was that terchnical details would be handled by the firm and he would neglect certain of these details such as securing signed margin agreements for margin accounts; and finally that Graham would call on corporate officers to solicit business and obtain information without [our] knowledge. This was an activity which [we] reserved to [our] research department and higher officers.

The Commission interviewed Graham on two occasions before his application was approved—on October 4 and 10, 1968. It was during the first interview that it was developed that the financial statement submitted with the application for registration was a personal statement and not a corporate statement. The discussion centered primarily on the valuations placed on his stock holdings. It was also developed that the $7,000 accounts receivable consisted of an estimated $3,000 due from his father and brother and approximately $4,000 due from his former employer for back commissions.

This interview should not be equated with an audit. For example, it was stated that stock valued at $515,000 was deposited with a bank to secure a $142,000 loan. It appears questionable whether stock of this value would be required to secure such a loan. The value of the stock was verified but the ownership was not verified. Moreover, the existence of the loan and its collateral was not confirmed with the bank. Also, the unverified accounts receivable are highly questionable.

The second interview concerned the corporate financial statement. The financial statement was not audited but a subordination agreement for the $25,000 loan was filed, therefore the only remaining item was the $5,000 cash deposit. However, as discussed below, despite the filing of a subordination agreement, the loan was never consummated.

This case points up the need to permit the Commission to bar entry of questionable persons. Although this individual had certain experience with broker-dealers as a registered representative, he certainly did not attain a reputation as being a desirable registrant. His activities were all tainted and conceivably a more thorough investigation may have proven violation of NASD and the Commission's regulations. The Commission attorney informed us that he knew at the time the application was approved that Graham would get into trouble but that he had no basis to bar his entry.

In regard to the filing of the first report of financial condition as of a date not more than five months after registration (due March 20, 1969), Graham requested and was granted an extension of time to

file a report as of January 31, 1969 on April 16, 1969. On April 14, Graham requested an additional extension of ten days—to April 26. (It was actually filed April 28.)

The files indicate that on March 17 (the date the Commission approved the first request for an extension of the filing date) the Commission's Regional Administrator requested an investigation of Graham and that an investigator visited Graham on that date.

The files also indicate that on this same day—March 17—the NASD reported that the net capital position of Graham was questionable and that Graham was making a market for a stock of a firm (Spectrum Resources, Inc.) in which Graham was a director and owned 47 percent of the stock but charged both a mark-up and a commission without disclosing his interest. There was no indication as to whether there was a formal report, whether NASD took any other action or what prompted the NASD investigation.

The SEC investigation of March 17 revealed:

(1) An audit as of January 31 was in process;

(2) Certain customers' accounts had not been posted January 31;

(3) Postings to the general ledger were such that it was impossible to determine the net capital position of the firm. No postings had been made recording "Stockholders Equity" or capital accounts of the firm;

(4) As stated above, Graham was to have personally loaned $25,000 to the firm on October 15, 1968 (five days before registration was approved) and a subordination agreement to this effect was filed with SEC on October 18. There was no indication in the records that the $25,000 had ever been deposited in the firm's bank account. The Vice President, Operations Director, and the auditor were all unaware that such a loan existed.

(5) Rules 8c-1(a)(3) and 15c2-1(a)(3) make it unlawful for a broker-dealer to hypothecate the securities of customers or subject them to any lien or liens which exceeds the aggregate indebtedness of all customers. In this instance the general ledger showed accounts receivable from all customers in the amount of $41,726,97. The firm carried margin accounts for some customers and in this connection as to February 28 the firm had bank loans totaling $119,000 and the bank was holding securities of the firm's customers as collateral on these loans. The postings to the margin accounts were not current and the firm's officials had no idea whether the $119,000 was more or less than the aggregate amount owing to the firm by such customers.

(6) The aggregate of six liability accounts amounting to $137,187.8 was improperly recorded. They should have been recorded as receivables as they represented funds advanced to Graham personally and affiliates of Graham in other businesses.

(7) The preliminary unaudited financial statement revealed that the firm's liabilities exceeded its current assets by $68,686.

A second visit to Graham was made by SEC representatives on March 24. At this time Graham was informed that the unsecured loans (the $137,187.8 mentioned above) to what appeared to be affiliated persons of the firm could not be included in net capital. There was also a considerable discussion about the Spectrum Stock—amount out-

standing, ownership, organization, interlocking directors, assets of Spectrum, etc.

On March 26, the Regional Office recommended to the Division of Trading and Markets that injunctive proceedings against Graham be authorized. The reasons cited were the finding of the March 17 investigation.

On March 28, the Commission filed a complaint for injunction against M. L. Graham & Co. and Graham in the U.S. District Court. The complaint sought a temporary restraining order, a preliminary injunction and final judgment, restraining the firm and Graham from effecting transactions in the purchase or sale of securities while the books were not current. Also, it commanded the firm to make and keep current its books and records.

On March 31, SEC representatives met with Graham and, among other things, Graham signed a stipulation and consent to the entry of the injunction being sought by the Commission. The "Stipulation and Consent to Entry of Permanent Injunction" was filed with the District Court on the same day—March 31. The court issued a "Final Judgment" on April 1, and appointed a receiver on July 9.

Of prime concern to this review is the fact that the receivers' second report indicates liabilities to customers amounting to $109,539. This consists of fully paid for securities, (1) used as collateral for loans from another broker-dealer ($33,826) and from a bank ($59,891) and (2) for which customers have substantiated claims but the receiver cannot locate ($15,822). Total liabilities amount to $297,640 of which $18,980 is preferred, $148,968 is secured, and $14,076 is taxes. Included in the other liabilities (totaling $115,616) is $56,908 payable to brokers. It is expected that the customers and brokers will lose all their funds as the receiver expects to realize only $2,969. Other assets considered unavailable amount to $291,516 of which $76,575 is receivable from Graham and $137,419 is receivable from Graham & Associates.

A hearing was scheduled on July 8, 1970, on the receivers' second report—the Commission files did not contain the transcript of these hearings. The second report contained a recommendation that the receiver be instructed to investigate the willingness of Graham to voluntarily place the company in bankruptcy, and in the event of said bankruptcy, to terminate the receivership. The outcome of this recommendation, and/or its progress, is not known. The Commission stated that it believed that the bankruptcy arrangement should be voluntary. An involuntary bankruptcy could not be filed because the required three creditors had not come forward.

As noted above, the receiver was appointed July 9, 1969, almost four months after Graham was found to be insolvent. However, it was not until January 23, 1970 that the court approved delivery to customer of fully paid stock in the possession of Graham.[1] It can be seen that this delay can cause serious hardship on the part of the customers since they are denied the right to sell the stock or use it as collateral for a loan. In addition, the receiver has the burden of dividend distribution in many instances because some stock is in street name. In this case, there were 32 customers with varying amounts of stock (15 to 2,000

[1] One customer brought suit on October 14, 1969, requesting delivery of his fully paid for stock but he was required to wait for the general distribution of all such customers.

shares) in their name and 17 customers with (12 to 7,500 shares) identifiable securities held in street name.

Moreover, this distribution was made to only a portion of the customers. In all there were 124 customers in eight general categories:

(*a*) Customers with securities in the possession of the receiver evidenced by certificates either in customer's name or in street name (54 customers).

(*b*) Customers with securities sent to transfer agents of the companies issuing the securities (30 customers).

(*c*) Customers with securities in the possession of brokers other than Graham subject to sale by such brokers to realize upon amounts due from Graham (6 customers).

(*d*) Customers with securities pledged to and in the possession of United California Bank (13 customers).

(*e*) Customers with securities in the possession of the brokerage firm of McNear and Kirchen or which McNear and Kirchen has rehypothecated to the Wells Fargo Bank (McNear claims that Graham had pledged certain securities to it as collateral for loans made to Graham) (5 customers).

(*f*) Customers with claims to securities in the possession of the receiver, which claims cannot be verified to Graham's records (44 customers).

(*g*) Customers with claims to securities which cannot be located (3 customers).

(*h*) Customers with securities due to Graham (3 customers).

Therefore, it can be seen that for the majority of customers (75 of 124) the wait for delivery is considerably longer than from March to January and as discussed above, in most instances will suffer a complete loss.

With regard to Graham's dealings in Spectrum stock, the Commission made an extensive study of known purchases. The results of this investigation were unfruitful, because interviews by various regional offices of purchasers revealed that they knew nothing of Graham—or anything about the stock they were purchasing. However, the Commission stated that it believed that these persons and especially the brokers were deeply involved in the illegal transactions and were merely unwilling to testify considering the possibility of incriminating themselves—especially since they made a profit. One aspect of the case was turned over to the FBI.

Appendix B–23

GREGORY & SONS

Gregory & Sons, a partnership, became registered with the Commission since April 23, 1939. Its headquarters office was in New York City, with branch offices in Potsdam, Rome, and Utica, New York, and in Honolulu and Los Angeles. It was a member of eight stock exchanges and the National Association of Securities Dealers.

Gregory's financial problems apparently began in 1969: there is no indication in the SEC files of any difficulties prior to that time. Gregory advised the NYSE on two occasions prior to filing its certified financial report as of July 27, 1969 that the report would show a net capital deficiency. The report, subsequently filed about September 9,

showed a net capital deficiency of about $500,000. Later, one of the partners, after reviewing the report, discovered that the public accounting firm had improperly included a substantial amount of restricted stock as an asset at full market value in the computation of net capital. This error resulted in an understatement of the net capital deficiency by about $4 million.

The NYSE informed the Commission of this error and of the serious financial condition of Gregory on October 14, 1969. The NYSE reported that Gregory needed capital in the amount of $5 million and had been attempting to obtain it by selling two seats on the NYSE for $700,000, selling branch offices, and disposing of the restricted stock. The NYSE believed, however, that even if all these things were done, Gregory would still be $1.3 million short. The NYSE imposed its usual restrictions.

On October 15, the SEC New York Regional Office held a conference with Gregory and its attorney to discuss the firm's problems. Gregory stated that the firm was not insolvent but lacked sufficient liquid assets. Gregory had sold two branch offices and planned to close six more branches by the end of October. The firm assured the Regional Office that its liquid assets would be sufficient to meet all outstanding public contracts.

Gregory stated it had been in daily communication with the NYSE since October 6 in an effort to resolve its difficulties. On October 14 the NYSE imposed its "no new asset" restriction on Gregory. As a result of these restrictions the firm ceased underwriting activities and was only continuing with syndication activities pursuant to outstanding agreements. In addition, the firm was only appearing in the pink sheets as a market maker in about 20 issues, for the sole purpose of liquidating the holdings of the firm and its partners and not for the purpose of a true market maker.

On October 23 Gregory was suspended as a member of the New York and American Stock Exchanges. The Boston and Philadelphia-Baltimore-Washington Stock Exchanges also suspended Gregory in the latter part of October. On October 24, the New York Stock Exchange appointed a liquidator for the firm.

On November 6, SEC authorized a private investigation of Gregory to determine whether Gregory had filed an inaccurate and incorrect financial report. The Regional Office held hearings on four days between December 30, 1969 and February 17, 1970 at which four partners of Gregory and two partners of the public accounting firm testified on the restricted stocks. The outcome of these hearings was not in the Commission files.

In an investigation progress report for the quarter ending December 31, 1969, the Regional Office reported that the partners of the accounting firm (one of the nation's largest) had admitted that their errors made during the audit had contributed in a material way to the filing of an inaccurate financial report by Gregory in September 1969. The partners were in the process of determining the full extent of their errors and planned to file an amended financial report in the near future.

As of January 4, 1971, the NYSE estimated that $5.94 million will be needed to meet the cost of liquidating Gregory.

Appendix B–24

HAYDEN, STONE, INCORPORATED

Hayden, Stone was founded as a partnership in 1892 and incorporated in 1962. Its headquarters office is located in New York City and as of August 3, 1969, it had 53 domestic and 10 foreign branch offices. It is a member of 9 stock exchanges, NASD, stock clearing corporations and numerous commodity trade associations.

Hayden, Stone reported that it encountered severe problems in 1968 in recording and clearing transactions and in transferring securities. The problems were created by the tremendous increase in volume and were compounded by difficulties in the application of an advanced computerized transfer security system. The firm stated its difficulties were more severe than other broker-dealers because its rapid growth, (both internally and through acquisitions) over the past 5 years caused substantial inadequacies in securities handling and orderly processing operations.

At the time of the firm's annual surprise audit as of August 30, 1968, a substantial amount of securities differences and uncleared transfers were revealed. At the time of the filing of the audit report on December 20, 1968, such differences totaled about $25,000,000 and the firm established a reserve of $12,663,000 for possible losses.

The firm reported that in May 1968 it adopted certain business restrictions designed to reduce its operations workload. Later in the year these restrictions were made mandatory by the NYSE. In November 1968 the firm closed 10 of its smaller offices and reduced its sales force by 200 account executives.

The New York Regional Office had considerable dialogue with Hayden, Stone since August 1968 in efforts to isolate their record-keeping difficulties, to insure that adequate steps were being taken to resolve those difficulties and to reduce the level of production in order to avoid additional problems.

The Regional Office reported that prior to October 1968, Hayden, Stone had voluntarily instituted a number of restrictions to limit input and simplify internal procedures. In October the firm imposed additional restrictions at the insistence of the Regional Office. These additional restrictions included, but were not limited to, limiting the average daily tickets to 7,500 a day, reducing over-the-counter buy orders by 33 percent and reducing the number of over-the-counter markets made by the firm from 150 to 25.

On October 24, the Regional Office advised Hayden, Stone of its concern with the firm's office operations in view of the continued record-keeping difficulties and the slow progress in resolving existing differences. It advised that additional restrictions were necessary, including a further reduction in the number of average daily tickets. Moreover, it indicated it intended to recommend to the Commission that private administrative proceedings be instituted against the firm to determine if there had been any violation of the Commission's bookkeeping rules. The firm stated that in order to avoid such a step it would undertake 14 steps to improve its operations. These steps included reducing the number of average daily tickets, exclud-

ing commodities, mutual funds and new issues, to 5,000 a day by January 1, 1969; not opening any new branch offices, except three for which the firm had been committed prior to May 1968; not employing any new registered representatives other than those then in training programs; and not to do any promotional advertising, except with the prior approval of the Regional Office. In addition, the firm agreed to furnish the Regional Office a weekly report showing, among other things, the number of average daily tickets written, the number of items and dollar amount of fails to deliver and fails to receive in total and those 30 days and older, and a computation of the net capital position.

On January 14, 1969, the Regional Office reported that Hayden, Stone, in response to a demand by the NYSE to further reduce the volume of their business, had given notices of termination, effective December 23, 1968 to 200 representatives, which was about 18 percent of its sales force. Counsel for the firm advised that this action would probably cause the transfer out of about 25,000–30,000 accounts. Hayden, Stone acknowledged that this was going to place a severe burden on their back office operations and further acknowledged that they did not know if they had the capability of balancing and transferring out that many accounts during the normal course of their business.

The Regional Office further reported that the NYSE advised it on January 3, 1969 that the Exchange had imposed a 26,000 ticket restriction per week, 5,200 a day, on Hayden, Stone. This restriction referred to all trades including mutual funds, underwritings and commodities. In addition, the Regional Office stated it had previously been advised by the NYSE that it had insisted that the firm raise $9 million additional capital. A later memorandum indicated Hayden, Stone had been able to raise only about one-half that amount.

Moreover, the Regional Office recommended (through the Division of Trading and Markets) that the Commission institute private broker-dealer proceedings to determine what remedial action should be taken against Hayden, Stone and its chief operating officer based upon violations of Section 17(a) of the Securities Exchange Act of 1934 and Rules 17a–3 and 17a–5 thereunder. The investigation was commenced February 3.

On February 19, Hayden, Stone informed the Commission of the actions taken and planned to improve the processing of transactions, the progress and future plans in locating and correcting errors and differences disclosed by the audit as of August 30, 1968, and negotiations to obtain additional capital. The firm reported it had a profit in 1968 of $1,500,000, attainable in part because no bonus was paid to any voting stockholders. A profit of $1,200,000 was forecast for 1969. The firm added $3,500,000 of capital in January 1969. On the other hand this was counteracted by the fact that as of February 18, there were requests for repurchase of stock, withdrawal of secured notes, or termination of subordinated accounts totaling about $3,558,000.

On September 25, 1969, the NYSE announced that it had fined the firm $150,000 and censured it relating to its 1968 difficulties. At the same time the NYSE indicated that the report of the independent

public accountant on the audit of Hayden, Stone as of August 3, showed that the firm had substantially improved its operational capability. On October 13, all NYSE restrictions and limitations on Hayden, Stone's business were removed.

Hayden, Stone reported that, contrary to its forecast of a profit, in the first eight months of 1969 the firm experienced a loss (after provision for year end payments, but before tax refunds) of $8,852,000, compared to a $5,089,000 pre-tax profit in the first 8 months of 1968. Total income during this period was $48,726,000, down $25,092,000 or 34 percent from the comparable period in 1968. While production expenses for the 8 months declined $8,796,000 or 38 percent to $14,094,-000, operating expenses remained approximately constant at $38,059,000.

The firm stated that the primary reasons for the losses for the first 8 months of 1969 were (1) the continuation of high operational costs incurred to resolve 1968 unsettled items and to reorganize processing procedures, (2) NYSE trading restrictions imposed on the firm, and (3) a reduction in overall stock market volume and the decline in security prices. It was believed, however, that the implementation of operating efficiencies should reduce processing costs to 1967 levels so that profitable operations could be obtained on substantially less volume.

On October 21, the Administrator, NYRO wrote the Chairman of the Commission that the NYSE had decided to remove all restrictions against Hayden, Stone which indicated to him that the Exchange believed the firm was well within the net capital ratio requirement. An analysis of the firm's recently filed financial report, as of August 3, made by his staff showed the ratio to be 2.824 percent. The difference was due to his staff disallowing certain non-liquid questionable assets. For example, among those assets disallowed was a $4 million plus item representing tax refunds the firm expected to receive. The Regional Administrator felt that this item was not a liquid 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 SEC net capital rules be deleted and that everyone, small or large, be required to live up to the same set of standards.

The Regional Administrator wrote the Chairman again on November 4, indicating that the specific items in the Hayden, Stone financial report did not trouble him quite as much as the entire approach of the NYSE in dealing with the net capital rule. He commented on the handling of insurance claims and the fact that the NYSE did not require firms to charge such claims against their net capital. This was followed by another letter on November 7 wherein he gave some background information describing the problems Hayden, Stone had been and was currently having, the financial condition of the firm, and his views as to what steps should be taken in connection with this firm. He painted a very bleak picture of Hayden, Stone's financial condition and was pessimistic about any significant improvements for the future. He made the following recommendations:

1. The Commission should force Hayden, Stone either to begin a retrenching by itself by imposing further restrictions or strongly suggesting to the NYSE to begin a liquidation of Hayden, Stone to a man-

ageable size on an orderly basis. Before taking any action, the Commission should give the firm an opportunity to raise the $6.7 million necessary to bring itself back within capital compliance. He believed this would be impossible and suggested that any time given to the firm be kept to a minimum, perhaps 15 days.

2. The Commission should suggest that the NYSE bring its trust fund into line with "real life" needs by assessing its members for further contributions because the "capital crunch" permeated the industry.

3. The Commission propose legislation and/or endorse appropriate legislation which would provide insurance for the investing public similar to that provided for the banking public.

On November 12, the Division of Trading and Markets sent a memorandum to the Commission stating that Hayden, Stone was in serious financial difficulty, primarily due to operating losses which amounted to $10,462,000 during the first nine months of 1969. Most of the firm's capital consisted of securities accounts subordinated to general creditors and demand notes collateralized by securities. A great deal of this capital was withdrawn in 1969 and millions more were scheduled for withdrawal in the foreseeable future. In addition, the firm was committed to expenses of $6.2 million in connection with its move to a new headquarters building in 1970.

The Division stated that its computation of Hayden, Stone's net capital showed the firm was clearly in violation of the NYSE's net capital rule. However, the NYSE considered unperfected claims as assets and had thus failed to find any violation of the rule.

The Division did not believe the firm's efforts to raise additional capital would be successful in view of its failure in the past to keep pace with withdrawals, let alone to add to its net worth.

The Division recommended that the NYSE be asked to submit an acceptable plan for the drastic retrenchment of the firm's business. The NYSE should also prevent the further withdrawal of subordinated capital, as scheduled, unless and until the firm's financial stability was assured. The Division recommended further that the plan fully protect the firm's customers or that the NYSE be asked to guarantee that the customers would not suffer a loss. In the event the NYSE was unwilling to adopt a suitable plan for dealing with the Hayden, Stone situation, the Commission would have to consider what steps it should take, including removing the exemption from the Commission's net capital rule which is now extended to stock exchange member firms.

On December 4, 1969, the Administrator of the NYRO wrote again to the Chairman. He stated that pursuant to the Chairman's instructions he had advised Hayden, Stone that the Commission would be willing to lift all restrictions provided it could raise sufficient new capital to bring it back within a proper net capital ratio. About $6.7 million in new capital would be needed but the Regional Administrator was sure the Commission would consider adequate an amount somewhat less than that as a stop-gap. He discussed the financial problems and forecast of the future with Hayden, Stone. He firmly be-

lieved that the firm was in serious financial difficulty and stood by his recommendations in his letter of November 7.

On December 10, the Division of Trading and Markets sent a memorandum to the Commission to apprise it of the above letter and recent developments on Hayden, Stone's financial condition. It stated that due to the firm's large losses and the withdrawals by capital contributors, the firm's net capital had shown a marked decline. It also stated the firm had suffered operating losses of about $300,000 in August; $1,400,000 in September; and $400,000 in October 1969. About $6,770,000 of withdrawals had occurred or was scheduled for the period June 1969 through April 1970. The firm had an income tax receivable of $7,185,000 which would improve its capital position after the tax return was filed—about February 1, 1970.

On December 17, the Division of Trading and Markets submitted another memorandum to the Commission. This memorandum stated that material submitted by the NYSE confirmed the view that the securities industry was experiencing financial problems which were testing individual firms and the regulatory process. The Division stated that because it could not be accepted that such a situation was "normal," it had prepared recommendations for Commission action with regard both to particular firms in trouble and to the securities industry in general.

With respect to Hayden, Stone, the Division urged that the Commission reject the NYSE's methods used for another firm as a model for the NYSE to follow the future cases of net capital violations by member firms. Specifically, the Division urged that the Commission make it clear to the NYSE that a lengthy work-out period would not be permitted for Hayden, Stone. The Division stated that in view of the fact that the firm would be in net capital violation in January 1970, barring an unexpected infusion of capital, the NYSE should be required to institute measures immediately to reduce the firm to a size supportable by its existing capital.

The Division stated that the NYSE should initially make the determination of what steps were necessary, but it believed that these should include the delivery out of customers' fully paid and excess margin securities and the sale of long positions owned by the firm. The staff would concurrently examine the restrictions then in force to determine which ones could be lifted because they were operational in nature and which ones should be retained in order to limit the exposure to customers. Also, the Commission should require weekly reports from the NYSE as to the financial condition of the firm.

On January 28, 1970, the Division of Trading and Markets informed the Commission that Hayden, Stone had advised it that as of December 31, the firm had excess net capital over the minimum of requirements of $3,891,000 and its capital ratio was 1374 percent. The Division stated the firm had included in its computation a capital contribution of $4,850,000 based upon an agreement with Walter E. Heller & Company to purchase a tax refund claim. The NYSE advised the Division that upon review of the contract for this contribution it would no longer give any credit for this item. The result of this was to leave the firm with a capital deficit of $959,000 and a capital ratio of 2253 percent.

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The Division reported that Hayden, Stone was negotiating the sale of its tax refund claim to another company in order to remove its capital deficit.

On March 12, the Division of Trading and Markets sent a memorandum to the Commissioners stating that according to an NYSE report Hayden, Stone had a net capital deficiency of $3,200,000 at the end of January and that the firm reported to the Commission staff that it had excess net capital of $1,954,000. It also appeared that the firm may have been in violation during the week of February 13 and that no report of this had been made to either the NYSE or the staff. We were informed that the net capital deficiency was only a technical violation.

In a memorandum to the Commission dated July 7, 1970, the Division stated that on June 26 the NYSE reported it had made a definitive computation and concluded that Hayden, Stone's net capital deficiency was approximately $8 million. It was reported that the NYSE's board approved in principle a plan whereby Hayden, Stone would:

1. Immediately raise $7,800,000 in additional capital by—
   (*a*) sale by the firm of certain restricted securities,
   (*b*) sale of subordinated securities, and
   (*c*) reduction of firm positions;
2. Continue its cost reduction program which it was anticipated would permit the firm to operate at a profit based upon an average NYSE daily volume of 7,500,000 shares;
3. Limit underwriting commitments to $1,500,000;
4. Be required to buy in all short stock record differences;
5. Freeze all capital in the firm until July 1971;
6. Take all steps necessary to obtain a tax refund as a result of a shortened year by closing their books on June 30 or September 30 and going to a June 30 or September 30 fiscal year;
7. Be placed on very stringent reporting requirements; and
8. Sign an undated liquidating agreement which the NYSE would be able to exercise in the event the firm did not carry out these undertakings.

Based upon the above understanding, the NYSE agreed to loan the firm $5 million for six months on a subordinated basis, to be repaid from the proceeds of the tax refund.

In the meantime, in March, Hayden, Stone entered into a series of agreements with a group of Oklahoma investors providing for additional funds for capital ratio purposes in the form of secured demand notes with an aggregate principal of $12.4 million and collateralized by securities with a market value of $17.5 million. The capital value of the collateral securities, as computed in accordance with NYSE rules, was $6,706,875 on May 31, 1970. As a result of the continued decrease in the market value of these securities, the capital value declined to $4,471,687 on August 20.

In May 1970, Hayden, Stone realigned its executive management and instituted a severe cost reduction program designed to reduce expenses by about $830,000 a month. The program included the discharge of over 400 employees, a 10 percent reduction in pay of salaried employees, a 15 percent reduction of pay of officers holding voting

common stock, and the consolidation and closing of several domestic and foreign branches.

Hayden, Stone reported that in June that it sold a substantial amount of its investment securities. In addition, in the following two months the firm liquidated substantially all of the securities held in subordinated accounts, liquidated all subordinated capital of voting stockholders and their spouses, and took certain other actions in order to maintain compliance with the NYSE capital ratio requirements.

On July 2, Hayden, Stone borrowed $5,000,000 from the special trust fund of the NYSE. The loan agreement provided that if repayment was not made by December 29, or if Hayden, Stone failed to meet the capital ratio requirements, was suspended or expelled as a member of the NYSE, or was, in the opinion of the NYSE, in such operating or financial condition that it could not be permitted to continue in business with safety to its creditors or the NYSE, the NYSE could appoint a liquidator to liquidate the business of Hayden, Stone. As of January 4, 1971, the Exchange disclosed that the amount of the loan to Hayden, Stone was $9,800,000 or approximately $4,800,000 in additional loans made since July 2, 1970.

On July 24, the landlord of the New York Plaza agreed to release Hayden, Stone from its obligations under a lease dated as of February 20, 1969 in consideration of the payment of $3,000,000 not later than September 15, 1970. As of August 26, Hayden, Stone was attempting to negotiate the extension of the payment of $2,000,000 of such amount to June 30, 1971.

On August 25, Hayden, Stone transferred to Walston & Co., Inc. all its customer and broker accounts, numbering about 23,000, in seventeen domestic branch offices. As part of the same transaction, Hayden, Stone transferred to Walston without cost, all furniture, fixtures and leasehold improvements, having a book value of about $95,000, and Walston assumed the lease obligations of, seven of the offices. Walston consolidated the ten remaining offices into its own branch offices and, as of August 26, Hayden, Stone stated it intended to terminate the leases for these offices as promptly as possible on the best available terms and to sell the furniture, fixtures and leasehold improvements.

Finally, the management of Hayden, Stone stated it believed that there was no foreseeable end to the continuing losses at a high rate and, as a result, in the near future the firm's net capital would not be adequate to meet the capital ratio requirements of the Exchange. Management had no prospects of being able to obtain a sufficient amount of capital to meet the capital ratio requirements.

On September 4, Cogan, Berlind, Weill & Levitt, Inc. (CBWL), a broker-dealer and Hayden, Stone entered into an agreement for the purchase of certain assets and properties of Hayden, Stone by CBWL.

Hayden, Stone agreed to transfer to CBWL (whose name was changed to CBWL–Hayden, Stone, Inc.) 28 domestic branch offices and $6,000,000 in cash, in exchange for (1) $3,000,000 of 8-year 10 percent subordinated debentures of CBWL–HS, (2) warrant to purchase 160,000 shares of non-voting common stock of CBWL–HS at $18.75 per share expiring concurrently with the maturity of the debentures, and (3) 422,750 shares of non-voting common stock of CBWL–

HS which would represent, after the issuance thereof, 20 percent of the total outstanding capital stock of CBWL-HS. The agreement provided that seven of the branch offices transferred could be liquidated by CBWL-HS at any time within six months if such offices failed to meet specified income levels. Hayden, Stone would pay all amounts attributable to net operating losses relating to any office disposed of. CBWL-HS acquired five seats on national securities exchanges and 20 seats on commodity exchanges under the agreement.

After consummation of the above agreement Hayden Stone's name was changed to HS Equities, Inc. (HSE). HSE retained all assets of Hayden, Stone not acquired by Walston and CBWL including cash and receivables, income tax refund receivable, any remaining assets in foreign branch operations, certain stock exchange memberships, contingent or doubtful assets, trading and investment inventories, sundry assets, and Hayden, Stone's interest in HayWood Management Corporation, Haygrove Corporation and Haycomber Corporation. HSE also is the owner of the debentures, warrants and stock provided in the agreement with CBWL. HSE retained all liabilities of Hayden, Stone not assumed by Walston or CBWL-HS. The business of HSE is to sell its assets and to repay its outstanding liabilities.

Appendix B-25

T. C. HORNE & CO., INC.

Registration

T. C. Horne of Cambridge, Massachusetts, became a registered broker-dealer with the Commission on April 19, 1967. At that time he was 22 years of age. His experience consisted of ten months as a registered representative with Bassuck Mutual Service Corporation. Although not indicated in the application for registration, he apparently was a part-time employee because at the time he was also a full-time student (senior) at Harvard College.

Horne became registered as the sole proprietor of Home Mutual Service Company. His financial statement listed assets of $4,711 and no liabilities. The assets consisted of $976 cash and securities valued at $3,735. The total assets met NASD and SEC requirements of $2,500 for sole proprietorship selling only mutual funds. In December 1967 the name of the company was changed to The Home Investments Co.

The financial statement as of August 31, 1967, four months after inception, shows assets of $5,528 and liabilities of $159. The assets consisted of $5,051 cash, commissions receivable $352 and office equipment $125. The liabilities were commissions payable. The capital account was $5,797 with $428 as "undistributed profit and loss accounts, including balances remaining in income and expense accounts."

This statement was filed November 15. It was due October 15 but a request for an extension was made and granted. In this regard it is noted that the Boston Regional Office (BRO) responded on August 11 to an inquiry explaining the pertinent points in the Rule 71a-5 and 17a-3. Apparently, Horne did not know what was expected of him.

Inspections

The BRO made three inspection visits to the registrants office between November 21, 1967 and March 26, 1968. These visits revealed that Horne lacked fundamental knowledge in record keeping. The ini-

tial inspection revealed the following bookkeeping deficiencies in Rule 17:

1. The books in general were not currently maintained.
2. Ledgers reflecting all assets, liabilities, income and expense, and capital accounts as required by paragraph (a) (2) of the Rule were not maintained.
3. Provision was not made for the proper ledger accounts for customers and brokers reflecting all purchases, sales, receipts and deliveries of securities pursuant to paragraph (a) (3).
4. Provision had not been made for a securities position record reflecting separately for each security as of the clearance dates all "long" or "short" positions in accordance with paragraph (a) (5) of the Rule.
5. No provision was made for a memorandum of each brokerage order as required by paragraph (a) (6) of the Rule.
6. Monthly proof of money balances of all ledger accounts in the form of trial balance and a record of the computation of aggregate indebtedness and net capital pursuant to paragraph (a) (11) of the Rule were not maintained.

BRO gave the registrant time to correct these deficiencies but the final visit revealed that although there had been improvement three of the accounts in the February trial balance were not ledger accounts. The reason for these deficiencies was:

The registrant has had two bookkeepers who . . . appeared to lack a basic accounting background and back office experience. The current bookkeeper is a first year student at Bently College of Accounting. The bookkeeper came to the Boston Regional Office for help in keeping the registrant's records, but a subsequent visit to the firm's office revealed a deficiency in bookkeeping fundamentals.

The inspection report also gives certain background information which is helpful in understanding why financial difficulties arose and the need for corrective legislative action to preclude this type of broker-dealer from becoming registered.

The registrant, a sole proprietor, is engaged almost exclusively in the sale of plans for the accumulation of shares in various investment companies. The proprietor, Thomas Horne, is a second year student at Harvard Law School. The registrant has a small office in the heart of Harvard Square, Cambridge. The regular office hours are from 2 p.m. to 5 p.m. Mr. Horne has over 30 part-time registered representatives who are, for the most part, students attending Harvard College.[1] As most of the students came from out of state, the registrant is licensed to sell in a number of states outside of Massachusetts.

The registrant has begun recently to sell general securities. Since Mr. Horne devotes only part of his time to the business, it appears that the problem of adequate control over salesmen may become a concern in the future. Inasmuch as the sales representatives are students, the turnover in personnel is rapid and the recruitment of sales representatives is continuous.

BRO informed Horne of the deficiencies listed above by letter dated April 9, 1968. However, the letter did not indicate that BRO intended to take any action. Rather, it merely asked Horne to acknowledge receipt of the letter and "indicate therein the corrective steps you have taken." Horne responded on April 11 stating that a bookkeeper had been hired and corrective action was being taken on each item listed.

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[1] NASD reported that by December there were sixty registered representatives in this category.

BRO was apparently satisfied with the response but a follow-up inspection was made six months later on October 21, 1968. This inspection revealed a number of bookkeeping deficiencies similar to the previous inspections. In a letter to Horne dated October 31, BRO pointed out:

1. The general ledger available during the visit was inadequate.
2. No trial balances of the general ledger were available.
3. No computations of net capital which are required monthly had been made as required by paragraph (a) (11) of Rule 17.
4. No securities position record was maintained.
5. Customers' accounts were not maintained for all customers, as required, particularly those purchasing full shares of investment companies where the shares were to be held by a custodian bank pursuant to such instructions.
6. Individual accounts were not being maintained for broker-dealers with whom you effected transactions.
7. Confirmation of transactions with customers did not fully comply with the requirements of confirmation Rule 15c1-4 in that principal and agency trades were sometimes listed on one confirmation without disclosing, as required, the capacity in which Horne acted in each transaction.
8. A test check disclosed 11 apparent violations of Regulation T of the Federal Reserve Board, wherein cash purchases were not paid for within the limits of the seven-day period prescribed by the regulation and these trades were not cancelled or otherwise liquidated on the seventh day, as required, and neither were extensions of time obtained in these cases as permitted by the Regulation.

It would appear that these deficiencies would have been sufficient cause for the BRO to seek an injunction against operations and the appointment of a receiver. This was not done, however, and the registrant was merely admonished:

> . . . of the concern of this Commission . . . of the importance which the Commission places upon complete compliance by a broker-dealer of all its rules and regulations.

In addition, the registrant was advised that if a subsequent inspection disclosed continued violations, the Regional Administrator may have no alternative but to recommend to the Commission that action be taken in connection with the registration. Also, as in the first instance the registrant was requested to acknowledge receipt of the letter and indicate the corrective action taken.

Horne responded to this letter on November 1, indicating that corrective action was being taken on each of the points. He added further:

> My problem was that I knew nothing about accounting, and could only afford to hire part-time help. I unwisely relied on my CPA and this part-time help to see that regulations were met. Now, I am taking an accounting course myself, so that I know what is going on, and I employ a full-time bookkeeper.

BRO inspected the registrant again on December 18. The inspection report states that "it appeared that an effort had been made by the registrant to comply with the Rule but certain inadequacies were still noted. The "inadequacies" included:

1. No general ledger book was maintained.
2. The position record was maintained with one sheet for each transaction rather than separately as to security.

3. No entries had been made on the customers ledger accounts from October 1 to about the first week in December.
4. The customers' and brokers' accounts appearing in the listing did not appear to agree with the individual balances in the accounts as of September 30, 1968.

BRO, however, did not write Horne regarding these "inadequacies." BRO was obviously remiss in this regard because, as discussed below, NASD conducted an inspection one week previously (December 10) and as a result of deficiencies noted, including failure to compute net capital which was not mentioned in the BRO inspection report, censured and fined the registrant.

A financial questionnaire for information as of December 31, 1968, was filed April 14, 1969, after requesting and being granted two extensions for filing. This statement showed cash of $10,067, salesmen advances of $9,978, office equipment $569 and short term receivables of $54,050. The short term receivables were agreements with 22 individuals to invest in a pending incorporation of the firm.

Based on this information, Horne was informed that the BRO computation to determine compliance with the net capital requirements under Rule 15c3-1 disclosed a capital deficiency in the amount of $14,922. No allowance could be made for the short term receivables mentioned above. The registrant was requested to take steps immediately to bring the net capital condition in compliance with the rule.

Horne appeared at the BRO on April 18 and argued his case. The conclusion reached by the BRO Administrator was that no action would be taken since the capital violation would be cleared up with the registration of the new corporation by the fact that the short term receivables would then be eligible capital.

Re-registration as a corporation

T. C. Horne & Co., Inc. became a registered broker-dealer with the Commission on June 13, 1969 based on a Delaware incorporation as of February 19, 1969.

The application listed three directors:

1. T. C. Horne was president. He was 24 years old at the time. He listed his experience, as noted above, as a part-time registered representative for 10 months with Bassuck Mutual Service Corporation and the two years he was president of Horne Investment Company. At the time he was also a student at Harvard Law School.

2. William R. Foster, director. He was 22 years old at the time. He listed his experience as concurrently being a registered representative with two security houses, a marketing trainee and a full-time student! It is recorded:

> From 6/65 to 5/67—registered representative with Bassuck Mutual Service Corporation (the same as Horne).
>
> From 6/66 to 5/67—registered representative with Nationwide Investment Services.
>
> From 2/67 to 5/67—marketing trainee with IBM. Received his BA degree from Harvard College 1967.

Moreover, he is listed as employed by Horne Investment Company from May 1967 to present (June 1969) as "Most Important Manager."

3. Anthony C. Castelbuono, director. He was 25 years old at the time and a student at Harvard Law School. He listed his experience

as being a law clerk in New York from 6/67 to 9/67 and from 6/68 to 9/68. This was obviously summer employment between semesters at Harvard Law School. However, he also shows concurrent employment with Horne Investment Company, being employed from 5/67 to present (June 1969) as secretary-treasurer.

BRO apparently did not question the qualifications of these individuals. In addition, it does not appear that BRO investigated the accuracy of the statements or verified the conditions upon which they departed their former employers. The files merely indicate that a search of SEC files revealed "No SV nor complaint references for applicant, principals nor connections within a three year period."

As a minimum BRO should have checked with NASD. A complaint was filed by the District Business Conduct Committee of District No. 13, NASD on March 3, 1969, resulting from a routine examination by the Association which commenced in December 1968. Horne answered the complaint on March 20, and requested a hearing which was held on April 9. The decision was not issued until October 9. Nevertheless, BRO should have been aware of the complaint and taken it into consideration at the time consideration was being given to the application for registration. The complaint was (1) failing to make and keep current certain books and records required by Rule 17a-3. Specifically:

(*a*) The general ledger was not available and trial balances were not prepared or if so not available for October or November, 1968.

(*b*) Ledger accounts for customers were posted only through the beginning of October, 1968.

(*c*) Failed to compute aggregate indebtedness and net capital monthly since membership in April 1967.

(*d*) Failed to maintain a securities or "position" record.

And (2) failed to establish and maintain written supervisory procedures for registered representatives and associated persons; further failed to endorse in writing, on an internal record, all transactions and all correspondence of his registered representatives pertaining to the solicitation or execution of any securities transactions.

Horne answered the complaints by pointing out, primarily, that no customers were injured in any way and that everything had been corrected prior to receipt of the complaint. Specifically with regard to the failure to compute net capital he attempted to mitigate the failure on the basis of what he considered limited applicability or seriousness when a dealer sells only investment company shares. Since the keeping of books and records is mandatory and the computation of aggregate indebtedness and net capital requirement is specific in regard to the registrant, he was found in violation of the rules.

The Committee concluded that the violations constitute conduct inconsistent with just and equitable principles of trade. Accordingly, the registrant was censured and fined $500 and assessed the costs of the hearing transcript and printing the decision amounting to $101.25.

BRO apparently waived the requirement that the financial statement be as of 30 days prior to filing an application for registration (June 2, 1969) as a statement dated April 30, 1969 was accepted. This statement shows net capital of $33,836 above the minimum requirement of $5,000; liabilities of $13,276 as opposed to allowable ag-

gregate indebtedness of $776,730. Of the total assets of $69,091, $42,818 was cash; primarily the newly infused capital of $65,000 (out of a total of $57,185) obtained from 23 friends of the three directors. The newly infused capital was greater than the total capital because the capital account of the Horne Investment Company as of March 31, 1969 amounting to $73,726 had to be reduced by $21,883 for the undistributed losses of its operations. BRO should have been aware that the company was faltering due to mismanagement and attempting to bail itself out by incorporation. The December 31, 1968 financial statement shows an undistributed profit of $1,202 whereas 3 months later there was an undistributed loss of $21,883.

On August 27, 1969, BRO wrote to Horne indicating that a computation based on the trial balance as of July 31, to determine compliance with the net capital provision under Rule 15c3-1 disclosed a net capital violation in the amount of $620. As in previous instances of net capital violation described above, the registrant was requested to acknowledge receipt of the letter and indicate the corrective action being taken. In addition, he was requested to furnish a monthly trial balance for the next six months. The SEC files do not contain a reply from the registrant to this letter. Trial balances are on file for August, September, and October. No explanation is given as to why the trial balances for November, December and January were not in the file.

BRO, however, obviously had a January trial balance because it wrote the registrant on May 21, 1970 and stated that a computation to determine compliance with the net capital provisions of Rule 15c3-1 based upon the January 31 report of financial condition filed pursuant to Rule 17a-5 on April 29, disclosed a capital deficiency in the amount of $6,179. The matter was academic, however, because BRO was aware that the registrant had ceased doing business May 4. This cessation of business coincided with a BRO inspection that commenced the same day.

NASD conducted a routine inspection of the registrant in December 1969. This inspection disclosed that on at least 30 occasions during the period from November 1968 to October 1969 the registrant failed to comply with one or more provisions of Regulation T of the Board of Governors of the Federal Reserve System. It also found that, similar to the previous NASD inspection, the registrant failed to endorse in writing, on an internal record, all correspondence of registered representatives pertaining to the solicitation or execution of any securities transaction. As a consequence, on May 1, 1970, Horne was again censured and fined $500. Horne accepted this penalty on May 4, the same day he ceased doing business.

BRO was also aware of the violations of Regulation T. A letter was written to Horne on July 8, 1969, pointing out that a review of the financial report as of March 31, disclosed a policy, in the case of fails to deliver, of shipping the securities involved "free" to the buying broker-dealer and then waiting for the payments to arrive at some future time. The Assistant Regional Administrator stated that this practice:

> . . . appears to me to constitute an act, practice, and course of business which operates as a fraud and deceit upon customers and a violation of applicable anti-fraud provisions, including Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10(b)(5) thereunder. Moreover, depending upon when payment is ultimately made, your failure to receive payment against delivery could well involve violations of the credit restrictions of Regulation T under the Act.

Unlike NASD, BRO took no further action as it apparently accepted an explanation submitted by Horne on August 7, 1969 in which he stated that the practice had been discontinued and was presently drafting securities through a local bank—a service which previously had not been available.

BRO did not receive official notice of the NASD December 1969 inspection and May 1970, fine of the registrant until July 24, 1970. Nevertheless, it was aware of the difficulties. It seems that in early 1970 BRO was about to undertake an inspection of Horne but postponed it when it was informed by the registrant's accountant, that an audit was to be undertaken. BRO received telephonic progress reports from the accountant to the effect that considerable difficulties were being encountered due to the condition of the books. BRO dispatched inspectors to the registrant on May 4 which was indicated to be the conclusion of the audit.

The certified statement as of January 31, 1970 was filed April 29. Although not indicated on the report, the auditor advised BRO by telephone that he had prepared voluminous entries adjusting errors in order to complete the books. In an affidavit filed in the District Court June 5, 1970, the Senior Securities Investigator of BRO stated he examined the certified financial report. This examination disclosed that as of January 31:

1. Aggregate indebtedness was $225,923.
2. Required adjusted net capital was $11,297.
3. Net capital was $9,297.
4. Required deductions from net capital was $4,179.
5. Adjusted net capital was $5,118.
6. Capital deficiency was $6,179.

This deficiency apparently could not be overcome. However, it is noted that Horne informed BRO on May 13, 1970, that in order to increase capital, in August 1969 he sold 20,000 shares of the parent company for $40,000, in January 1970 one of these purchasers loaned $25,000 to the parent company, in December 1969 and January 1970 a corporation loaned $34,000 to the parent company, in January 1970 his brother-in-law loaned $10,000 to the parent company and in April 1970 a friend loaned $25,000 with warrants to the parent company. In addition, Horne personally contributed an additional $6,000 to the parent company.

The BRO inspection of May 4, 1970 disclosed that Horne's "books and records," although current, were inaccurate to the extent that it would be necessary for a new set of books to be established for the period from February 1, 1970 to date. (The audit was as of January 31, 1970.) In excess of $90,000 was due from customers as of May 4, (Regulation T violation), the registrant had $346,000 overdrafts at its bank (there was an $18,613 overdraft at October 31, 1969, but apparently no action was taken by BRO when this information was received on December 2, 1969). In addition, the General Ledger, and Customers' and Brokers' Ledgers and the Security Position Records, although posted through January 31, 1970, contained voluminous errors and inaccuracies and required substantial corrective entries. The extent of the inaccuracies in Horne's books and records precluded a determination of the net capital position or taking a trial balance."

As a consequence, on May 21, 1970, Division of Trading and Markets (DTM) recommended to the Commission that private administrative proceedings against the registrant be instituted.

A memo dated June 4, 1970 from DTM to the Commission recommended that BRO institute an injunctive action against the registrant and seek the appointment of a receiver. It further stated that the January 31, 1970 financial data reflects a net capital ratio of 4,414%—a net capital deficiency of $6,179 (aggregate indebtedness $225,923). It further stated:

> Because of the failure of Registrant to properly post its books and records beginning February 1 to the present date, Registrant is totally unable to ascertain its financial condition through its inability to balance its books. Further, Registrant cannot identify the owners of approximately $50,000 or more in securities which have been found in Registrant's possession. The stock is in the name of various persons with a majority of shares in street name.
>
> Registrant is insolvent. It has issued bad checks to customers in the amount of $2,000 and has $50,000 in uncollectible accounts receivable.
>
> * * * * * * *
>
> The Boston Regional Office was not prepared to recommend also alleging violations of Section 10(b) and Rule 10b-5 of the Exchange Act, although the firm was doing business at a time when it was unable to determine its financial and net capital condition and when it was insolvent. Horne indicated he would consent to the injunction against violations of Sections 15(c)(3) and 17(a) but would contest a fraud charge because he is applying for admittance to the Massachusetts bar, and a fraud injunction would adversely affect his application.

A complaint and motion for a temporary restraining order were filled in the District Court on June 5, 1970 and a preliminary injunction was issued on June 8.

In a memo from DTM to the Commission dated July 22, requesting a formal order of investigation, in addition to the deficiencies noted above, it was pointed out that:

> It now appears that during the period from at least April 1970 to June 5, 1970, the Registrant held itself out to the public as ready and able to do business, and continued to engage in the business of broker-dealer, while failing to disclose to customers that it was insolvent and unable to meet its current obligations as they became due (Registrant filed on June 5, 1970, under Chapter XI of the Bankruptcy Act proposing a Plan of Arrangement with unsecured creditors, showing assets of $110,500 and liabilities of $143,000).

The record of the extent of Horne's business is not clear. NASD stated that as of December 1969 there was a Cambridge office and "there were additionally six branch offices, a total of 132 registered representatives." The DTM memo dated May 21, 1970 states that registrant "employs 55 persons, 31 of whom are part-time salesmen." NASD further stated that the registrant conducted a general securities business, whereas, as mentioned above, SEC contends the business consists of retailing over-the-counter stocks and mutual fund sales.

The files contain several complaint letters. These letters, however, for the most part were received after SEC had already taken action which resulted in placing the registrant in receivership. The first letter received in January 1970 requested a full scale investigation of Horne and one other broker-dealer without furnishing any information other than the contention he had been "gyped." Those letters which explained their complaint were all regarding failure to deliver securities and pertained to sales as far back as October 1969; for the most part the sales were in the first few months of 1970.

The files do not contain any information as to commissions earned and/or profit or loss from operations after April 1969. Nevertheless, at that time losses were commencing to mount. As business increased losses increased requiring the infusion of more and more capital. Horne did not trade in its own account. The losses occurred because of mismanagement. Although many office expenses appeared reasonable, Horne had no concept of cost accounting and probably was not aware that commissions paid were exceeding income. Records were not currently maintained and, just as significant, Horne did not understand the books and records nor appreciate their significance.

Summary

This case is a prime example of the need to strengthen the requirements for becoming a registered broker-dealer. Increasing the present capital requirement of $5,000 will not be a sufficient deterrent alone to strengthen the registration requirements. In this instance the registrant had ample capital (by $5,000 standards) when he became incorporated and evidenced an ability to substantially increase this amount. The fact that the registrant was extremely young should not in itself lead one to believe that consideration should be given to having a minimum age requirement. On the other hand, a young age is usually accompanied by a lack of experience. In this instance, it is obvious that one with only a limited amount of experience as a part-time registered representative is not qualified to be a broker-dealer.

Appendix B–26

HOUSTON SECURITIES CORPORATION

The Houston Securities Corporation became registered with the Commission as a broker-dealer September 27, 1960. The firm had three employees in its one office in Houston, Texas. In September 1968 a salesman joined the firm and operated out of his home in Jackson, Mississippi, selling primarily mutual funds. Houston was a member of the National Association of Securities Dealers, but was not a member of a national stock exchange.

The Commission reported that the firm was primarily a wholesale dealer, trading with other broker-dealers in low priced over-the-counter stocks. Stock transactions with general-public customers constituted perhaps 5 percent of the firm's business and mutual funds were about 10 percent of gross sales.

Houston's problems stemmed from alleged violations of the securities laws by selling unregistered stocks of 3 shell corporations, artificially creating and maintaining market prices for the stocks and, while participating in the distribution of the stocks, bidding for and purchasing such securities for accounts in which it had a beneficial interest and inducing other persons to purchase the stocks prior to completing the distribution. For two of the stocks Houston and its president used an unregistered interstate broker-dealer as an intermediary in order to conceal the source of the stock. The intermediary's registration with the Commission had been revoked in 1962. The alleged violations occurred during various periods between August 30, 1968 and September 30, 1969. The Commission began uncovering these

violations sometime prior to June 5, 1969 during its investigation into possible manipulative practices being used in the trading of one of the three stocks.

On August 5, 1969, the Commission filed a complaint with the U.S. District Court regarding two of the stocks. On November 3, 1969, the Court issued an order preliminarily enjoining Houston, its president, and 12 other defendants from further violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Act of 1934 in connection with the offer and the sale of the two stocks.

On February 19, 1970, the Commission issued an order instituting public proceedings against Houston and its president. On May 19, the Commission accepted an offer of settlement from Houston and its president in which they consented to an order barring the president from association with a broker-dealer. They also agreed to withdraw their appeal from the preliminary injunction and to the entry of a permanent injunction. The Commission set July 20, 1970 as the effective date of the withdrawal of Houston's registration and of the bar order on its president.

APPENDIX B–27

THE KENTUCKY COMPANY

The Kentucky Company became registered with the Commission as a broker-dealer on December 27, 1951. It was a member of the Midwest Stock Exchange (MWSE) and the NASD. Its home office was in Louisville, Kentucky and it had branch offices in Owensboro and Paducah, Kentucky. The firm engaged in underwriting, distributing and dealing in municipal, railroad, public utility, industrial and mutual fund shares specializing in local securities and Kentucky municipal bonds. Mr. Holman R. Wilson was the president, and principal share holder of the firm.

The first indication of difficulties occurred on July 23, 1969, when a check to another broker-dealer was returned for lack of sufficient funds. This was followed by the firm arranging for an audit of its books and records as of August 31, 1969. The auditors reported that the firm's treasurer—who had been obtained by Kentucky from the accounting firm—allegedly had been guilty of a misappropriation of funds. The discovery was made on September 1, 1969 and he was released from all duties the following day. The auditors also stated that the general accounting records of the firm were not in balance and supporting subsidiary records were substantially out of balance with the general ledger control accounts. According to the auditors this condition was created by the firm's treasurer.

The auditors further stated that it may be necessary for the filing of a substantial claim with the bonding company, but there was no reason to believe that the firm was not meeting the MWSE net capital requirements, nor was there reason to believe that the firm had been in violation subsequent to August 31, 1969. On November 14, 1969, the president of the Kentucky Company sent a copy of the letter from the firm's auditors to the MWSE and to the Commission's Chicago Regional Office, together with a request for a second extension of 30 days to December 15 for filing its financial report for 1969 as required under Rule 17a–5 of the Commission. The report was due to be filed

with the Commission by November 15, based on a previous Regional Office acquiescence to a request for an extension of time of 30 days. The second request for an extension of time was granted in part to December 1. A request for a third extension was denied by the Regional Office.

The firm finally filed a tentative uncertified and qualified audit report on December 15, 1969 with the Regional Office. The report disclosed that the firm had a net capital deficiency of about $436,000. (The Regional Office reported that the MWSE computed the deficiency to be about $515,000.) According to the audit report the capital deficiency was due chiefly to missing securities amounting to about $490,000 and cash amounting to about $143,000. These amounts equaled approximately the amount of the firm's net worth and actually the firm was deriving its working capital from customers' free credit balances aggregating $253,057 which it was not in a position to pay.

On December 22, the Regional Office held a conference with officials from the firm. its insurance company and the MWSE and informed the parties that the insurance claim could not be recognized in the computation of net capital and that since a substantial net capital deficiency existed with the elimination of the insurance claim, the firm was told to cease operations. On the following day, the MWSE Executive Board agreed with the Regional Office's position and the firm terminated its business with the understanding that it would not resume its business until sufficient capital was obtained.

On January 8, 1970, the firm failed to meet a $14,900 obligation and therefore the following day, the MWSE suspended the firm and its president for the stated reason that the firm was in a dangerous financial condition and unable to satisfy contracts.

On January 15, the Commission filed a complaint in a U.S. District Court seeking an injunction and the appointment of a receiver for the Kentucky Company for allegedly having violated net capital requirements and having effected transactions with customers when it was unable to meet its obligations as they matured. On the same day the Court issued a preliminary injunction against the firm and appointed a receiver to take charge of all assets and property of the firm.

The Regional Office, estimated in May 1970 that over $400,000 may be necessary to cover the excess of claims over assets.

It appears that the MWSE could have taken more timely action in this case. Once it had learned that a substantial claim would be filed with the bonding company, it appears that an appropriate action by the MWSE would have been to send in its own examiners to determine the seriousness of the firm's condition. However, this was not done, and the only action taken was suspending the firm four months after the facts were known.

As to the timeliness of the Commission's actions in this case, we have noted several instances where other broker-dealers requested one or more extensions of time for filing their financial questionnaires and the Commission shortly thereafter sent an investigator to the firm to inspect the books and records. There is no indication the Regional Office did this in this case. Its financial report was originally due October 15, 1969 and the first actions taken by the Regional Office were on December 22.

Appendix B–28

LOWELL & CO.

Lowell & Co., a California corporation became registered with the SEC as a broker-dealer on June 1, 1968, when it succeeded Loeb & Lowell, Inc. The latter firm, also a California corporation, became registered on September 17, 1967. The principal office was in Beverly Hills, California, with branch offices in San Diego, California and Sherman, Oklahoma. Lowell & Co. was a member of the National Association of Securities Dealers but was not a member of a stock exchange. It dealt principally in over-the-counter securities.

Lowell's financial difficulties commenced approximately in July 1969, one year after inception. At that time there was a loss of $70,000 due to the failure of a customer to settle his account. An additional loss of $96,173 was incurred in September on securities ordered by five customers who refused to accept delivery.[1] Lowell's failure can also be attributed to losses incurred in large investments in a Canadian stock that was placed on the foreign restricted list and investments in other low priced speculative stock.

As of June 30, 1969, Lowell had a net capital deficiency of $10,556 including a bank overdraft of $244,000. This deficiency was corrected in July primarily by the subordination of two loans totaling $105,000 (one from a client and one from a registered representative.) As of July 31, there was a net capital surplus of $51,826. However, as of August 31, there was again a net capital deficiency—amounting to $116,429.

Lowell again took corrective action by obtaining a subordinated loan of $200,000 on September 29. In this instance the agreement also provided that Lowell would transfer its cashiering business to a subsidiary of the lender [2] and give the lender an option to acquire Lowell. There were no capital deficiencies as of September 30, October 31, or November 30.

Nevertheless, the Commission contended it maintained close surveillance over the firm because of the large inventory of low grade speculative stocks and large balances in customers accounts receivable and the fact that it appeared that operating losses were being incurred each month. However, the effectiveness of this surveillance appears somewhat questionable. The Commission computed Lowell's net capital as of November 30 on January 12 to be in compliance with requirements. Two weeks later, on January 28, the Commission was informed by Lowell that it had discontinued handling new security business on January 23. Although the Commission granted standby authority to go to court to attempt to obtain an injunction against the firm, such authority was not used because on February 12 Lowell filed a petition under Chapter XI of the Bankruptcy Act.

Lowell informed the Commission that it would make sure that the liquidation of customers' accounts was handled in an orderly and ex-

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[1] Also at about this time, the brother of the president and an employee, misappropriated approximately $27,665 from the company. Although this contributed to the liquidity problem at the time, there was no loss to the firm because the bonding company made full restitution.

[2] Lowell was apparently amenable to this provision since it was having difficulty with the existing cashier firm as evidenced by the fact that an accurate analysis of operating results for August of certain financial details were not available until the end of September.

peditious manner. Nevertheless, it has been estimated that customer losses will amount to $152,700 and losses to other broker-dealers will amount to $47,300.

Lowell reported that as of June 30 fails to deliver amounted to $1,082,511 (of which $245,447 was outstanding 30 days or longer) and fails to receive amounted to $1,191,704 (of which $345,076 was outstanding 30 days or longer). Although in certain respects this problem was as significant as the net capital deficiency which existed at the time, there is no indication that corrective action was taken. The amount of fails is not indicated for any other date except that an undated worksheet indicates that the deductions ("haircuts") in net capital computation for fails over 40 days from August 31, 1969 through January 2, 1970 amounted to $439,945. Conceivably, the large amount of fails could have been one of the most significant factors among Lowell's financial difficulties. It undoubtedly was a major factor in the amount of losses incurred by customers and other broker-dealers when Lowell went into bankruptcy.

This case typifies the conclusion that considerable customer losses can be incurred by relatively small broker-dealers and the fact that the Commission is not equipped to deal with the situation. Although the Commission was aware of Lowell's financial difficulties, it took no action against the firm apparently because it was able to regain capital compliance shortly after deficiencies were noted. There is no indication that the Commission was aware of the sizeable operational losses being incurred until after the firm voluntarily ceased operations. The Commission requires the periodic submission of financial data pertaining to capital position but does not require submission of operational data. It would appear, as in this case, that operational results are as significant as capital data in evaluating the status of a broker-dealer.

Appendix B-29

MC DONNELL & CO., INC.

McDonnell & Co., Inc. had been registered with the Commission as a broker-dealer since January 1, 1959, to a predecessor partnership which had been registered since April 1, 1939. McDonnell was a member of the New York Stock Exchange, American Stock Exchange, several regional exchanges and the National Association of Securities Dealers. At one time it had as many as 26 branch offices in the United States and France.

The files of the Commission show that McDonnell began having financial and operational difficulties in 1968. A public accounting firm conducted the annual surprise audit of McDonnell as of October 31, 1968. The firm concluded, in a report dated March 12, 1969, that McDonnell was faced with serious problems in its back-office and in meeting the net capital requirements of the NYSE. The Commission had inspected the main office of McDonnell on July 11, 1968 and had not found any violations of the record keeping or net capital rules and regulations. Because the public accounting firm found an entirely different situation less than four months later, there appears to be some question as to the adequacy of the Commission's inspection.

The public accountants found that there had been a significant increase in record keeping errors as compared with the situation at the time of its examination in October 1967. The ratio of aggregate in-

debtedness to net capital was 3,027 percent. Factors cited as contributing to the high ratio were:

1. Differences in the securities record relating to unlocated securities ($1.3 million);
2. Amounts required to cover deficits in customers' partly secured and unsecured accounts ($1 million) and to certain customers' margin accounts ($268,993); and
3. Dividends uncollected at the conclusion of the auditor's examination ($872,491).

The public accountants further reported that there was no doubt that underlying many, if not all, of the matters previously discussed was the exteremely rapid growth which the firm had experienced. Indicative of this fact was that customer accounts numbered approximately 47,500 in calendar year 1968, compared to 17,500 in 1964.

In addition to the reasons the public accountants gave for the problems McDonnell was encountering, McDonnell's Chairman of the Board later cited the following reasons for the subsequent closing of the company:

1. Sudden death of the Chairman's brother who had played a key management role until June 1968;
2. Untimely deaths of the firm's comptroller and of its senior Vice President for Operations in 1968 and 1969;
3. Failure of a new computer system to operate as it had been planned; and
4. Compounding of the back-office problems (paperwork) during the latter part of 1968 when stock brokerage volume was at a record level, the sharply declining stock market of 1969, and the subsequent drop in brokerage volume and other investment banking activities.

It was disclosed by the Commission that the accountant's report aroused the interest of the NYSE and the Commission, and McDonnell had been under scrutiny since the fall of 1968. In addition to the monthly operations questionnaire, the NYSE required McDonnell to file supplementary reports commenting on rates of correction in the back-office and on progress and problems in conversion to a new type automated system. A weekly estimate of McDonnell's capital position was also required.

In April 1969 McDonnell operated under self-imposed restrictions. These restrictions included (1) no new branch offices; (2) no compensation to salesmen on buy orders of listed securities under $5 a share or on purchases of listed bonds when the commission was less than $12.50 per trade; (3) limitations on trading over-the-counter securities selling for under $5 a share; (4) no odd-lot over-the-counter orders having a total value of less than $1,500; (5) reduction of firm trading practices to a minimum; (6) no new sales training classes; and (7) no advertising designed to attract new business.

On May 21, 1969, the NYSE told McDonnell that additional limitations were necessary. NYSE required the following:

1. No approval of the registration of any new registered representatives or producing allied members;
2. The number of trades must be limited to 12,000 per week, including underwritings; and
3. All advertisements and sales promotion was prohibited except for that incidental to underwritings.

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As examples of McDonnell's operational problems, it was reported that at one point in 1969 there were 4,000 errors in 47,000 customer accounts, dividends uncollected by the firm for its customers totaled $872,000, and McDonnell had on hand $9 million in securities for which it did not know the rightful owners. On the other hand, the firm owed $1.3 million in securities to customers and other brokerage firms, but it could not locate the securities.

The Commission stated in late 1969 that progress had been made in certain areas towards resolving some of the problems related to the company. As an example, in January 1969 there were 4,897 fail to deliver items with a market value $22.8 million (1,337 items with a market value of $6.6 million outstanding 30 days or longer). By October 1969 McDonnell reduced these figures to 1,671 items with market value of $9.3 million (415 items with market value of $1.2 million outstanding 30 days or longer).

Similar data was reported for fails to receive. There were 6,847 fail to receive items with a market value of $30.1 million in January 1969 (3,173 items with market value of $12.4 million outstanding 30 days or more). By October 1969 McDonnell reduced these figures to 974 items with market value of $5.0 million (171 items with market value of $726,000 outstanding 30 days or more).

Other problem areas included (1) stock record differences, (2) differences in "in-house" count of all of its securities, and (3) errors in the dividend accounts.

The Commission conducted a random examination of its 1969 customer complaint file for McDonnell. Of the 104 complaints reviewed, 12 were related to dividend deliveries, 43 concerned delivery of stock, 7 were related to transferring accounts to other brokerage firms, and 42 dealt with inaccuracies in account statements.

Other statistics show that McDonnell estimated customer complaints in 1969 to be as follows:

	Feb. 27	Mar. 27	Apr. 27	May 29	June 26	July 31	Aug. 28	Sept. 26
Total	450	300	300	500	350	200	300	500
Unresolved	200	50	40	200	200	100	100	200

The Commission reported that in 1969 McDonnell had been either in violation of the net capital rule of the NYSE or on the verge of such violation. McDonnell's books and records difficulties were cited as a contributor to the problem. The following net capital ratios were listed for McDonnell & Co. for 1969:

Feb. 27 (percent)	1890
Mar. 27	[1] 1741
Apr. 24	1957
May 29	2312
June 26	[2] 2813
July 31	2151
Aug. 28	1613
Sept. 26	2239

[1] NYSE examiners computed this figure as 2628 by deducting from net capital the market value of non-current short dividends, 30 percent of short security differences and an estimated tax refund.

[2] From this date forward, no deduction for short security differences was made. SEC reported that the NYSE permitted McDonnell to adopt this procedure on June 6, 1969 when the two parties agreed that since long differences exceeded shorts, no capital charge was necessary.

The Commission stated that because McDonnell's records were inaccurate, the above cited figures were to be regarded as some indication of the condition of McDonnell's back-office rather than a precise and reliable statement of its net capital, fails, stock record differences and dividend accounts.

During calendar year 1969, McDonnell tried with little success to bring in new capital. As of November 1969, it was reported that all branch offices except those in New York and Paris were sold or liquidated. The Commission reported that McDonnell had at one time 40,000 customer accounts, however, in November 1969 that McDonnell had roughly 5,000 accounts.

The Commission stated that the major effort needed to transfer the accounts from the liquidated branches to the brokerage houses acquiring them would probably prevent any appreciable improvement in the operations picture for some time. The manpower that would have to be applied to this task would have necessitated neglecting other back-office problems. McDonnell appeared to have been incapable of dealing with more than one back-office problem at a time.

McDonnell's public accounting firm had completed its audit for 1969 and submitted its report during the week of March 8–14, 1970. The report showed that the company's financial condition had worsened significantly. Upon receipt of this report, the Commission contacted the New York Stock Exchange and after discussions, the NYSE decided to liquidate McDonnell. NYSE appointed a liquidator for the firm in March 1970. As of January 4, 1971, the NYSE estimated that $8.98 million from its special trust fund will be needed to meet the cost of liquidating McDonnell.

In November and December 1969 the New York and Washington Regional Offices recommended that public proceedings be authorized against McDonnell and fifteen of its officers and employees. This recommendation was based on McDonnell's back-office problems and for other violations of the rules and regulations. The Headquarters' staff did not submit its recommendation to the Commission until March 16, 1970, or about three months later. This staff stated that it had been prepared to submit its recommendation earlier; however, discussions were being held during this period with McDonnell & Co. and T. Murray McDonnell, Chairman of the Board, in regard to an offer of settlement consenting to the alleged violations and to revocation of the firm's registration. Offers were submitted by McDonnell & Co. and T. Murray McDonnell on March 13, 1970.

The staff stated further that, because of the seriousness of the charges against McDonnell and others, it was important to institute public proceedings as quickly as practicable. However, the actual timing had presented problems since the NYSE had not completed arrangements to liquidate McDonnell. It was pointed out that the order that was to be issued by the Commission would precisely provide that nothing would, in any way, limit the liquidator from taking all action necessary to insure an orderly liquidation. NYSE wanted the Commission to defer its action until the liquidation of McDonnell was fully completed (estimated to take six to eight months). The Commission stated that such action would have been inconsistent with its functions and contrary to the public interest.

On April 9, 1970, the Commission issued its findings and an order imposing remedial sanctions for the firm and its Chairman of the

Board. The Commission revoked the registration of McDonnell as a broker-dealer, but provided that the firm could do all that was necessary to effect an orderly liquidation of its affairs, and permanently barred T. Murray McDonnell from assuming any managerial or supervisory position with any broker-dealer without the prior approval of the Commission.

The above findings and order did not consider the other violations of the rules and regulations and the fourteen remaining officers and employees involved therein. The administrative proceeding ordered by the Commission on April 9, 1970 continued. These violations had been detected in 1969 by the Commission through investigations at McDonnell's Asbury Park, New Jersey, Washington, D.C., and New York City branch offices. The violations at the Asbury Park and New York branch offices involved making false and misleading statements of material facts and omitting material facts necessary in order for the statements not to be misleading in connection with the offer and sales of two stocks; the failure to make reasonable and diligent inquiry and the disregard of the past and present financial condition and business operations of the two issuers of the stocks; and the failure to reasonably supervise employees to prevent the violations. The violations at the Washington, D.C. branch office involved inducing customers to engage in securities transactions which were excessive in size and frequency, establishing margin accounts and effecting transactions for customers without authorization, and the failure to reasonably supervise employees to prevent the violations.

On October 20, 1970, the Commission issued its findings and an order imposing remedial sanctions concerning the violations of the officers and employees at the Asbury Park and New York branch offices. The Commission accepted offers of settlement from seven persons and imposed the following sanctions: suspension from association with any broker or dealer for fifteen days for one person, ninety business days for another person, three months each for two persons, five months for one person, six months for one person, and a censure for one person. The Commission stated that four of the persons receiving suspensions of ninety business days, three months, five months and six months were not then engaged in the securities business. Their suspensions began that day.

On March 10, 1971, the Commission issued another findings and order imposing remedial sanctions concerning the violations of one salesman of the New York branch office and one salesman and the manager of the Washington, D.C. branch office. The Commission accepted offers of settlement and imposed the following sanctions: suspension from association with any broker-dealer for a period of six months for the salesman of the New York branch office, suspension from association with any broker-dealer for a period of ten business days for the salesman of the Washington, D.C. branch office, and censure and suspension from any managerial or supervisory position with any broker-dealer for a period of nine months for the manager of the Washington, D.C. branch office.

As of March 29, 1971, the Commission has yet to take final action against four remaining employees of the firm, two in each of the New York and Washington, D.C. branch offices.

In regard to the net capital problems experienced by the McDonnell & Co. during the fall of 1968 through March 1970, it is appropriate to point out the manner in which a firm having net capital problems is dealt with depending on whether it is an exchange or Commission regulated firm. McDonnell being a member of the NYSE was subject to its net capital rules and was exempted from the net capital rules of the Commission.

Our review disclosed that McDonnell & Co. was in violation of net capital rules and the NYSE allowed them to continue in business for an extended period of time. It appeared that the NYSE simply carried 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 between 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.

APPENDIX B-30

MIDWESTERN SECURITIES CORPORATION

The Midwestern Securities Corporation became registered with the Commission as a broker-dealer April 13, 1968, with its principal offices in New York City. Lloyd W. Sahley was the president, treasurer, and owned more than 25 percent of its outstanding equity securities. Midwestern was a member of NASD but was not a member of an exchange. Midwestern principally conducted an institutional business.

Midwestern's problems stemmed, at least in part, from an underwriting it agreed to undertake for the stock of Transceiver Corporation of America. An underwriting agreement dated September 2, 1969 between Midwestern and Transceiver provided that Midwestern would underwrite the offering of 130,000 shares of Transceiver stock to the public at a price of $9 a share (aggregate sales value of $1,170,000) on an all or none basis.[1] The prospectus and a letter agreement between Midwestern and the escrow agent (bank) provided for the return of funds to the purchasers in the event that all of the 130,000 shares were not sold within 60 days. It was also stated in the agreement that in the prospectus for the offering that the proceeds from the sales of the stock would be promptly deposited in a separate bank account as agent and for the benefit of Transceiver.

However, although not disclosed to the public, the underwriting agreement was cancelled on the same day it was signed and they entered into another agreement shortly thereafter (date not indicated). The second agreement, in contravention of the provisions in the prospectus, did not provide for the deposit of the sales proceeds.

At the time of the second agreement Midwestern had $309,951 on deposit with the escrow agent. Midwestern authorized the escrow agent to remit this balance to Transceiver and Midwestern signed a

[1] On November 3, 1969, the Commission stated that the then current bid price of the stock was quoted at $4.

promissory note for the remainder, $735,549. Transceiver delivered 34,439 shares of stock to Midwestern for the cash payment and deposited 95,561 shares with the escrow agent in exchange for Midwestern's promissory note. The note provided that Midwestern would pay the $735,549 as follows: $150,000 by October 1, 1969; $150,000 on or before October 15, and the balance on November 9. Midwestern forwarded additional deposits of $93,849 to the escrow agent and received 10,427 shares of stock in return for such deposits. As can be seen, this was insufficient to satisfy the note. Moreover, it was reported that neither Transceiver nor Midwestern was financially able to return the funds raised from the public.

On October 27, 1969, the Commission conducted an inspection of Midwestern and found that Midwestern's blotters did not show the receipt and delivery of Transceiver stock and did not show entries for fails to receive and delivery of Transceiver stock. In addition, the blotters did not show the promissory note from Midwestern to Transceiver.

The inspection also revealed that the customer ledgers were incomplete. They failed to show the sales of Transceiver stock, i.e., 38,034 shares were posted out of a total of 44,856 shares known to have been sold. In addition, the general ledger had been posted only to October 10, and the stock records, posted only to September 2. These records did not show the Transceiver transactions.

Midwestern indicated a net capital deficiency of $975,569 as of October 24, based on its own computation.

On November 5, the Commission authorized the filing of separate complaints seeking (1) to enjoin Transceiver and Midwestern and its president from further violating the anti-fraud and prospectus provisions of the Federal securities acts in connection with a public offering of Transceiver stock and to restrain them from using the proceeds of such offering, and (2) to enjoin Midwestern and its president from further violating the net capital and bookkeeping provisions of the Federal securities acts. A receiver for Midwestern was not recommended. A Commission investigation of Midwestern was opened the same day.

On November 7, complaints were filed and the court issued a judgment of permanent injunction on November 19. The order restrained and enjoined Midwestern from transferring or disposing of any assets until the firm was in compliance with the Commission's net capital and bookkeeping rules.

In an investigation progress report for the quarter ending March 31, 1970, the Regional Office stated that the investigation was proceeding with a view towards recommending administrative proceedings against Midwestern and its president. In the following quarter, the U.S. District Court was petitioned to appoint a receiver for Midwestern and Transceiver.

There are no financial statements or other financial or operating data in the Commission's Headquarters office files as of July 29, 1970, except for the data relating to the public offering of Transceiver stock noted above. At least three financial statements should have been filed by this time: (1) within 30 days of filing for registration; (2) not less than one month or more than five months after becoming registered with the Commission (April 13, 1968); and (3) for 1969.

Appendix B–31

V. F. NADDEO & CO., INC.

V. F. Naddeo & Co., Inc. became registered with the Commission as a broker-dealer January 9, 1961. It had one office in New York City. It was a member of the NASD but was not a member of a stock exchange.

The NASD informed the Commission orally in February, 1970, that Naddeo was in trouble. The Commission files do not disclose the type or degree of the problem because everything reportedly was handled orally. It is not known how NASD detected the problem. The files for another broker-dealer, Paul F. Newton & Company, revealed that Naddeo probably incurred financial problems when the Newton firm was unable to pay for about $330,000 worth of stock it had purchased from Naddeo in December 1969.[1]

The New York Regional Office was apprised of the information on February 12, 1970, which led to the filing of a complaint in the U.S. District Court on February 13, 1970, to enjoin Naddeo and its president and sole stockholder from further violations of the net capital and bookkeeping provisions of the Securities Exchange Act of 1934. On the same day the court appointed a receiver for the firm.

On February 20, 1970, the Regional Office approved an investigation of Naddeo to investigate fully the above violations and any other violations and to recommend what, if any, further action should be taken. There was no indication in the files as to the status of the investigation at the time of our review at the end of May 1970. However, it is estimated that other broker-dealers will incur losses amounting to $100,000 but no customer losses will be incurred.

Appendix B–32

NAFTALIN & CO., INC.

The Naftalin & Co., Inc. (NCI), a Minnesota corporation, became registered with SEC as a broker-dealer February 25, 1960. It had one office located in Minneapolis, Minnesota. The firm had three officers, only one of whom was actively engaged in the operation of the business, the president, Mr. Neil T. Naftalin. NCI was a member of the National Association of Securities Dealers and the National Security Traders Association but was not a member of an exchange. At its outset the firm conducted a general securities business. Commencing in 1962 the firm changed the character of its business to that of a market maker,[2] whereby it dealt only with brokers and dealers and not with members of the public.

NCI voluntarily informed SEC of its financial difficulties by letter dated October 27, 1969 indicating the firm was insolvent and unable to deliver securities to cover open trades with other brokers. SEC apparently had not previously been aware of the difficulties of the firm. SEC conducted regular investigations and operational checks of the firm. The most recent operational check, as of June 16, 1969 (four months

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[1] See case study of Paul F. Newton & Company, Appendix B–33.

[2] SEC report dated June 16, 1969 shows no issues in which the firm was a market maker, therefore it would appear that this type of business had ceased by that time.

prior to insolvency) disclosed no violations of regulations or operational problems. On the other hand, the firm failed to file or request an extension for filing its financial questionnaire due July 31, 1969. This should have been an indication of impending difficulties but SEC records do not reveal that they were aware of the deficiency at the time. The reports that were filed with SEC revealed a high level of fails to deliver and receive in relation to the company's total capital. Although this would appear to indicate overextension or undercapitalization, SEC officials informed us that they are not primarily concerned with this fact. Rather, they merely check to determine that fails to deliver and receive are not unduly out of balance.

The primary cause of the firm's financial difficulties appears to be a number of irresponsible actions by the firm's president which were not ascertainable from reports normally submitted to SEC or by SEC operational reviews. The NCI's president stated that commencing in August 1969 he did not post short sales because such postings would have revealed a net capital deficiency. Between August 1 and October 2, 1969, the firm effected short sales totaling about $8.6 million. These short sales, when bought in by the corresponding brokers after Naftalin revealed that it was insolvent, resulted in losses in excess of $1.2 million.

SEC obtained a preliminary injunction against the firm and its president on November 4, 1969. On December 2, the State of Minnesota revoked the firm's broker-dealer license and on December 23 a receiver was appointed for Naftalin.

Once the firm's difficulties were discovered, SEC actions appear to have been timely and adequate. SEC quickly obtained a preliminary injunction and then showed evidence to the court that a receiver should be appointed to save about $605,000 worth of U.S. Treasury Bonds which were in the possession of the firm's president and whose ownership was disputed. SEC has been pursuing administrative proceedings against the firm and its president.

This case typifies the problems that may well be incurred by SIPC in that considerable losses can be incurred in a relatively short period of time that cannot reasonably be expected to be detected by a surveillance program.

Appendix B–33

PAUL F. NEWTON & CO.

Paul F. Newton & Company was incorporated in Texas on April 18, 1962, as Associated Petroleum Brokers, Inc. On November 18, 1968, the firm amended its articles of incorporation to change its name to its present name. The firm had one office located in Houston, Texas. Effective September 16, 1968, it became a member of the National Association of Securities Dealers, Inc., and on April 16, 1969, it was admitted to membership on the Philadelphia-Baltimore-Washington Stock Exchange.

Newton's financial problems and subsequent insolvency resulted from the purchase in December 1969 of 49,000 shares of Imperial Investment Corporation stock costing over $963,000, based on orders from five individuals in New York. On February 24, 1970. Paul F. Newton, president of the firm, signed an affidavit in which he stated

that according to his best recollection he first learned on December 26, 1969, that the Newton Co. had purchased the stock for the five persons. He said that all orders accepted by the Newton Co. for the five persons were entered into on a payment against delivery basis. In connection with several purchases of Imperial by the Newton Co. the broker-dealers in New York from whom the stock was purchased were selected and designated by the customers. All of the orders for the stock were made by the five persons in December 1969 and the orders placed by them were unsolicited. The Commission stated that one of these individuals had a long criminal record and had been enjoined several times for violating the laws administered by the Commission. The individuals refused delivery of the stock when it was tendered to them, except for 1,000 shares costing $15,615.

On December 26 and 29 Newton called two of the individuals regarding payment for the stock and was assured that the funds would be forthcoming.

On January 5 and 6, 1970, Mr. Newton and an attorney visited two of the individuals in New York City for the purpose of determining whether better arrangements could be made for the payment of the Imperial stock. Prior to January 5, Mr. Newton had never met any of the five persons. They were again assured that all the stock ordered by them would be paid for.

Mr. Newton stated that the Newton Co. had ordered from various broker-dealers 22,000 shares of Imperial stock at a cost of over $300,000 which the firm had not paid for. In light of the fact that the five persons had not paid the Newton Co. for 48,000 shares they had ordered, the Newton Co. was in an insolvent condition on January 13, 1970 and ceased placing orders for the purchase or sale of securities on such date.

Although the orders for purchases were made by the five persons from December 2 to December 26, 1969, the Newton Co., as of February 9, 1970, had not cancelled or otherwise liquidated such orders.

On January 21, 1970, the Philadelphia-Baltimore-Washington Stock Exchange informed the Commission that Newton had been suspended from the Exchange effective on that date for apparent violation of the net capital requirements and aggregate indebtedness limitations of the Exchange.

In a memorandum of February 6, 1970, the Fort Worth Regional Office recommended that the Commission authorize it to file a complaint in the proper court seeking to enjoin Newton from further violations of the Securities Exchange Act of 1934 and the appointment of a receiver. This recommendation was based on Newton's transactions in Imperial stock and the firm's admission it was insolvent. On February 17, the Commission approved the staff's recommendations.

On February 24, the Regional Office filed a complaint with the U.S. District Court. On the same date the Court entered a preliminary injunction enjoining Newton and its president from continuing the violations set forth in the complaint, and appointed Newton's counsel to collect and preserve the assets until further order.

In an investigation progress report for the quarter ending June 30, 1970, the Regional Office stated that counsel for Newton informed the court that Newton desired to have a receiver appointed to not only

collect and preserve the firm's assets but to institute suit against various parties.

It seems that Newton did not use good judgment and caused its own downfall. The receipt of an order by a Texas firm for almost $1 million for the stock of one corporation from five individuals living in New York should have raised some inquiry into their background and financial responsibility. Newton was also deficient in not cancelling or otherwise liquidating these purchases for over six weeks; instead Newton allowed the individuals to reassure it that payment for the stock would be made.

Newton ended up owing four other broker-dealers almost $453,000 for stock it could not pay for; including over $330,000 to V. F. Naddeo & Co., Inc. This loss was a contributing factor to the financial collapse of Naddeo, another firm we reviewed. The Regional Office reported on February 6, 1970 that Newton owed five customers $44,000.

Appendix B-34

PACIFIC SECURITIES COMPANY

Pacific Securities Company became registered as a broker-dealer with the Commission on April 10, 1968. Its main offices were located in Salem, Oregon; branch offices were located in Eugene and Corvallis, Oregon; Tustin and San Diego, California; and in New York City. Pacific was a member of the National Association of Securities Dealers but was not a member of an exchange.

Its business was largely in underwriting new issues and maintaining secondary markets in securities which it had originally distributed. Between January and October 1969, Pacific participated as a managing underwriter, underwriter, and as a member of a selling group, in 16 underwritings (12 of which were Oregon companies). It had approximately 700 customer accounts, and at the time its offices were closed its records showed approximately $1,000,000 in receivables, $1,000,000 in payables and $500,000 in inventory (at cost). It has 33 salesmen and 20 clerical employees.

J. Richard Deal was president, director, and owned 50 percent of the outstanding stock. His wife, Barbara Deal, was secretary, director and owned the other 50 percent of the stock. Mr. Deal is a former minister of the Assembly of God Church. He entered the securities business in November 1964 as a securities salesman (primarily underwriting new issues) for local securities firms.

Vincent J. Pepe, manager of Pacific's New York office from May to October 1969, was responsible for much of the securities business in the New York area, in spite of his failure to pass the NASD examination preparatory to becoming a registered representative for Pacific.

The Commission made its first inspection of Pacific in October 1968, six months after operations commenced. The inspection revealed violations of SEC's bookkeeping rule. These deficiencies were reportedly corrected within the month and all self-imposed restrictions were removed.

Despite the deficiencies revealed by the first inspection and the known inexperience of the firm's principals, a further inspection was

not made until August 1969. This inspection revealed that a number of serious deficiencies had existed at least since the preceding January. These deficiencies included violations of rules pertaining to net capital, failure to maintain records, Regulation T, false records, failure to transmit complete underwriting proceeds, and failure to maintain a sufficient cash position.

With regard to net capital, the Commission determined that a deficiency existed every month ending from January through July. Although the amount of the deficiency was $5,000 one month, for five of the seven months the deficiency was over $51,000.

Pacific attempted to correct the net capital deficiency in August by the addition of $58,500 of subordinated capital. However, further examination disclosed that certain receivables represented either fictitious transactions or receivables in which there was little likelihood of payment. After making adjustments for uncollected customers' accounts receivable and inventory, as of September 30, 1969, the net capital deficiency increased to $86,000.

Pacific's operations were first stringently limited, and then closed in October 1969 by order of the Oregon Corporation Commissioner because of the firm's insufficient cash and failure to honor drafts from other dealers.

Immediately prior to suspension of the firm, the Commission's investigation disclosed that approximately $262,000 of receivables from customers were based on fictitious sales, at least $183,000 of which pertained to the stock of the Datatronics Leasing Corporation, an issue for which Pacific was the Regulation A underwriter and principal market maker. The New York office sales manager had suggested that customers place orders for shares being offered in the over-the-counter market with the understanding that payment need not be made until resale of the shares by Pacific for the customer at an increased price. The customers were also told that if the price of the stock decreased the transactions would be cancelled. The sales manager also placed orders in the name of customers for his own benefit although he did not intend to make payment unless the securities could be sold at a profit. Also; as a consequence of these fictitious sales, although the issuer was advised by letter dated September 2 that the entire issue was sold, Pacific was in a position to remit only $100,000 of the $261,000 due ($300,000 less commission of 32½ cents per share on the sale of 120,000 shares at $2.50 per share).

In addition to the obvious fraud involved in these transactions, it should be noted that the activity during the period of the public offering created an exaggerated impression of investor interest in Datatronics stock. Pacific openly made a market in and bought and sold shares of Datatronics stock after the closing of the public offering and until all operations ceased in October 1969.

Also, it was reported that, while participating in a distribution of Pixieland Corporation 8¼ convertible subordinated debentures on a best efforts basis, Pacific failed to promptly transmit funds received to the issuer. It was not indicated whether this was caused by fictitious sales or other reasons.

It was further reported that during September 1969, the NASD and the Commission received at least six complaints regarding failure of the firm to honor drafts with securities attached from other dealers.

Also, the firm had a bank overdraft during this period in excess of $100,000 and it continued to add to the overdraft by writing additional checks totaling $70,000. The failure to honor the dealers' drafts and overdrafting its bank accounts was caused by a heavy inventory of securities for which Deal had been underwriter or market maker, and in which the market had become depressed.

A review of approximately 40 percent of Pacific's customers' accounts for the period November 1968 through July 1969 disclosed 80 transactions in 48 accounts where payments were received from two to 89 days beyond the time permitted by Regulation T. In an additional 47 transactions in 42 customers' accounts during the period September 5 through October 14, 1969, payment had not been received within the time required. Also, 42 separate securities were purchased without prior payment in 18 special cash accounts. It was further reported that as of the August 8, 1969 inspection, the position record had not been posted since February—approximately 5½ months.

On November 17, 1969, Pacific filed a petition in the U.S. District Court for an arrangement under Chapter XI of the Bankruptcy Act. Efforts to obtain additional financing failed so in January 1970 the referee adjudicated Pacific a bankrupt and ordered the trustee to proceed with an orderly liquidation of the firm. It is estimated that as a result of the liquidation customers will incur losses amounting to approximately $150,000 and other broker-dealers will incur losses amounting to approximately $80,000.

Mr. Deal, president of the firm, was apparently not considered culpabel in the fradulent transactions. On June 2, 1970, the Commission approved a recommendation for private administrative proceedings against Pacific, Mr. Deal and Mr. Pepe. However, as of June 30 the Commission reported that negotiations were being carried on with counsel for Mr. Deal for a stipulated statement of facts for an offer of settlement. Nevertheless, in the meantime while these negotiations were being carried out and while Pacific's liquidation was in process, Mr. Deal was instrumental in organizing a new securities firm. First, Cascade Securities, Inc. First Cascade became registered as a broker-dealer with the Commission on April 11, 1970—two years and one day after Pacific became registered.

The fact that Mr. Deal is not considered culpable to the fradulent transactions is somewhat questionable. Although he was probably correct in his denial of any knowledge of the fraudulent transactions perpetrated by the New York branch office manager, it would seem that he was still responsible for seeing that, under proper management, sales to customers were promptly cancelled when payment was not timely received as required by Regulation T. Moreover, it seems appropriate to question the basis upon which the Commission proposes to assure protection to customers of the new firm against the same type of unscrupulous activities and mismanagement that typified Pacific's operations and resulted in considerable losses to customers.

This case exemplifies the need for more stringent qualifications for registration as a broker-dealer. The president of Pacific was inexperienced and a branch office manager was incompetent. Moreover, despite the original failure in the securities business, the president was permitted to re-enter the business without any indication that an improvement can be expected.

This case also exemplifies the need for more stringent surveillance. In this instance although the Commission's first inspection was timely, based on the findings of the inspection, a second inspection should have been in less than 10 months. Obviously customer and other broker-dealer losses would at least have been lessened if Pacific had been forced to cease operations sooner. Also, with regard to the subject of surveillance, it should be noted that although Pacific was a member of NASD, the Commission files do not reflect any actions taken by NASD.

Appendix B-35

PHILLIPS (LOWELL) & COMPANY, INC.

The Phillips (Lowell) & Company, Inc. became registered with the Commission as a broker-dealer on December 4, 1968. Richard Lowell Phillips was the sole stockholder of the firm. It was a member of the NASD but was not a member of a stock exchange. It was organized specifically to act as firm-commitment underwriter for Lane Industries, Inc. The Lane Industries registration with the Commission became effective at approximately the same time and covered 165,000 shares at $3 a share.

Lowell had financial difficulties from inception in that its application for registration revealed a net capital deficiency. The deficiency was purportedly corrected by a subordination agreement for $130,000. However, the subordination agreement was a sham because it was doubtful whether the firm ever had access to the funds. When the Commission inspected the firm in May 1969 there were net capital deficiencies of $116,072, $59,646 and $101,467 for the months ending February through April 1969, respectively. Other violations detected included the commingling of customers' cash and securities, hypothecation of customers fully paid for securities, and the transaction of business while insolvent.

The Commission disclosed that the firm had on deposit in checking accounts with two banks a total of $3,604, and at a third bank it had an overdraft of $27,431 as of April 30, 1969. Also, Lowell's inventory of securities on the same date was less than $3,000 in miscellaneous securities and some 14,256 shares of Lane Industries, Inc. carried at a book value of $239,310; however, the market value was only $167,-508. Accordingly, the Commission found the firm to be insolvent as of April 30, by $7,874. On a liquidating basis the insolvency would be substantially larger since the firm's receivables were considered to be of a doubtful value, and since the market for Lane Industries, Inc. stock was very thin.

The Commission issued a formal order of investigation on May 19, 1969. On May 26, the Commission filed a complaint in the U.S. District Court, and on June 2, the Court permanently enjoined the firm and its president from purchasing and selling the common stock of Lane Industries, Inc. or any other security. Also, the Court appointed a special officer to supervise the collection and preservation of the firm's assets. A hearing was held on June 16, 1969, and as the result, the Texas State Securities Board revoked Lowell's registration.

Lowell is an example where a firm encountered problems immediately after becoming registered. It would appear that an inspection one or two months after the firm became registered would have been the only way of detecting Lowell's problems.

Appendix B-36

PICKARD & COMPANY, INCORPORATED

Pickard & Company became registered with the Commission as a broker-dealer on March 13, 1962 and as an investment adviser on November 24, 1964. Pickard was a member of the National Association of Securities Dealers and engaged in a general over-the-counter retail securities business until December 20, 1963 when it became a member firm of both the American and New York Stock Exchanges.

John Pickard and his brother, Peter Pickard, were the only beneficial owners of 10 percent or more of any class of Pickard's equity securities.

Pickard had about 18 subordinated lenders with a total investment in excess of $1 million. Pickard had its principal place of business in New York City and had operated five branch offices in Point Pleasant, New Jersey; New Castle, Pennsylvania; Youngstown, Ohio; Phoenix, Arizona; and Miami, Florida.

Pickard had a history of serious violations commencing with the first examination of Pickard conducted in November 1963 pursuant to its application for membership in the NYSE. At that time, instances were noted in which Pickard failed to record the receipt and delivery of customers' securities in the appropriate accounts; non-purpose loans were made to customers against securities not readily marketable and deficiencies existed in the non-purpose loan letters; Pickard charged customer commissions on transactions in which it acted as principal; and customers' fully paid for and excess margin securities were not properly segregated. It was also noted that Pickard's back-office consisted only of one man.

On January 28, 1964, a NYSE examiner visited Pickard pursuant to its application to become a regular NYSE clearing house member. It was reported that Pickard's back-office was not adequately staffed to perform the functions of a regular clearing member and NYSE concluded that it was questionable whether the corporation would be in a position to maintain adequate clearing operations. Pickard informed the NYSE that it would employ an experienced cashier upon its becoming a regular clearing member and assured the NYSE that it was fully capable of handling the additional workload. In February 1964 Pickard was admitted as a regular clearing member of the NYSE.

On June 16, 1964, the Business Conduct Committee for District No. 12 of the NASD censured and fined Pickard for violating its Rules of Fair Practice. Pickard permitted five persons to perform the functions of a registered representative from December 20, 1963 to about March 24, 1964 without first causing those persons to be registered with the NASD as registered representatives. Three of the five were officers of Pickard.

The financial report filed with the Commission by Pickard as of November 12, 1964 disclosed that customers' securities having a value of about $122,247 were pledged as collateral for firm loans. This violated Rule 402 of the NYSE and Rule 8c-1 of the Commission. It was subsequently brought to the attention of Pickard by the NYSE on January 29, 1965 when the NYSE again advised Pickard of the necessity for prompt and accurate segregation of customers' free and excess margin securities.

A report prepared by a NYSE examiner dated April 22, 1965 on a visit to Pickard disclosed, among other thins, that:

1. A review of Pickard's cash accounts for the month of March, 1965 showed numerous violations of Regulation T where funds to pay for securities purchased were received from 2 to 15 days late and no extensions of time were requested or obtained;
2. A review of the records for proxies showed that the proper procedures were not being observed;
3. There was no procedure for verifying changes of address of customers' accounts;
4. Pickard's records were one week late in posting;
5. A review of the order tickets for one week disclosed that many sales tickets were not marked "long" or "short"; and
6. A review of the "accounts payable miscellaneous" which had a balance of $57,794 as of March 31, 1965, disclosed numerous unpaid bills dating back to May, 1964.

In regard to the above, John Pickard testified that he and his brother were forced to assume the entire responsibility for operating the firm as none of the other officers fulfilled their obligations and he could not rely on the employees. Investigation, however, disclosed that Peter Pickard devoted more than half of his time to affairs entirely unrelated to the business of Pickard and that John Pickard's normal business day consisted of opening and distributing mail, interviewing job applicants, watching the ticker tape, etc.

The net capital computation prepared by Pickard as of April 30, 1965 disclosed an aggregate indebtedness of $1.4 million and net capital of $70,909 for a ratio of 1,989 percentum. However, an analysis of the Pickard computation by NYSE examiners showed that, as a result of an adjustment to net capital, the ratio of aggregate indebtedness to net capital was actually 2,710 percentum. In August, a review of Pickard's records by NYSE examiners as of June 30, showed aggregate indebtedness of $2.2 million and net capital of $82,000 resulting in a ratio of 2,642 percentum. In July, additional capital stock was purchased by officers of Pickard, inventory positions with an approximate market value of $100,000 were liquidated and the firm temporarily discontinued endorsing options, resulting in an increase in net capital and a corresponding reduction in ratio to 1,335 percentum as of July 31. The firm's loss from operations as of that date amounted to $348,261.

On January 11, 1966 the NYSE censured Pickard for violating NYSE Rule 325 by permitting the net capital ratio to exceed the minimum net capital requirement.

On March 30, 1967 Pickard was again censured by the NASD and

fined $3,000 based upon findings that Pickard had committed the following violations:

1. During the period from January 1, through May 30, 1966, Pickard failed to register with the NASD six persons who were performing the functions of a registered representative;

2. During the period from June 1965 through May 1966 Pickard executed as principal a series of transactions for customers at prices which were excessive and not reasonably related to the then current market;

3. During the period from about July 9, to about December 7, 1965, Pickard failed to promptly cancel or otherwise liquidate a series of transactions by customers as to which payment had not been made within seven full business days from the date of purchase, in contravention of Section 4(c)(2) of Regulation T;

4. During the period from December 1 to about December 15, 1965, Pickard executed transactions of purchase in a customer's special cash account without there being sufficient funds in the account to cover such purchases, in contravention of Section 4(c)(8) of Regulation T;

5. During the period from at least June, 1965 to at least June, 1966, Pickard failed to make and maintain records; and

6. During the period from September 1965 to at least June, 1966, Pickard failed to take appropriate measures to assure adequate supervision of Pickard's registered representatives.

A visit to Pickard by a NYSE examiner in March, 1966 disclosed violations of Sections 3(b)(2), 4(c)(2) and 4(c)(8) of Regulation T.

On June 24, 1966 an NYSE examination of Pickard revealed that the firm had overstated its net capital by $187,334 resulting in an adjusted ratio of 1,814 percent, as of May 31, 1966. Also, it was revealed that no attempt had been made to segregate customers' free or excess margin securities for at least three months and that a complete breakdown of the segregation system had taken place; customers' securities were used for bank loans without written consent, and hypothecation agreements were missing for more than 50 percent of margin customers' accounts in letters A–C; etc.

As a result of an adjustment by NYSE examiners in Pickard's net capital computation as of June 30, 1966, its net capital was reduced from $268,247 to $182,902 causing a ratio of 2,532 percent.

Commencing June 30, 1966 the NYSE restricted Pickard from hiring any additional salesmen; opening new branch offices; trading in excess of $100,000 for the firm account, accepting any new margin accounts with significant debit balances; engaging in underwriting; and effecting any new transactions for the conversion account, in addition to the prior restriction imposed on Pickard in 1965 requiring it to maintain a net capital ratio of 1,500 percent.

However, subsequent inspections by NYSE and the Commission revealed that the firm had violated many of the restrictions imposed upon it by the NYSE and employed a number of devices designed to circumvent the imposed restrictions.

On February 7, 1967 the NYSE again censured Pickard and fined the firm $5,000 for having violated NYSE Rules 325, 402, and 405(3)

and Section 8(c) of the Exchange Act and Rule 8c-1 thereunder. The NYSE informed the Commission on February 13, of this disciplinary action NYSE stated that Pickard officials were warned that should there be any evidence in the future of their inability to conduct their corporation's affairs in accordance with the rules and regulations, it may result in formal proceedings before the full Board of Governors, leading to suspension or expulsion.

In March 1967, Pickard arranged to open a branch office in Miami, Florida, employing about ten registered representatives and trainees accounting for about 20 percent of its overall business. Pickard offered to close down its other major branch office in Phoenix, Arizona. Pickard opened the Miami branch and then informed the NYSE that the landlord of its Phoenix office would not release it from the lease. Pickard did close two temporary one-man branch offices in Sedona and Cottenwood, Arizona and the NYSE permitted it to keep open its Miami office.

In connection with the restriction of the number of its registered representatives, Pickard literally permitted almost everyone of its employees to effect transactions for customers and paid them a commission in the form of an incentive bonus, mid-term bonus, quarterly bonus or year-end bonus. Trainees performed the functions of registered representatives as did persons working in the various back office departments.

The Commission reported that in order to maintain the firm's net capital ratio below 1,500 percent, Pickard withheld from the firm bills totaling in excess of $200,000, switched from an accrual basis to a cash basis of accounting and only recorded these bills when actually paid. These bills were never included in Pickard's net capital computations. The Commission further reported that in April 1967, the NYSE examiners learned that Pickard was continuing to accept new margin accounts with significant debt balances.

On December 18, 1967 and again on January 26, 1968, Pickard's auditors notified the NYSE of the difficulties they were experiencing in completing the audit and stated that they would not be able to express an opinion on the financial statements. Shortly thereafter, NYSE called a meeting of Pickard's officers and notified them that an additional $500,000 in capital would be required immediately. No action was taken by Pickard and on February 2, the NYSE sent 20 or more of its staff to Pickard in an attempt to clear up the "back-office" problems. Pickard finally filed its financial report as of September 30, 1967 on June 26, 1968. The report disclosed that customers' fully-paid-for and excess margin securities having a value of $578,449 were hypothecated with banks as collateral for firm loans. Although the report was attested to by Pickard to be "true and correct," the auditor's report stated that because of deficiencies in the records and internal accounting controls of Pickard, they were unable to make an examination in accordance with generally accepted auditing standards.

The New York Regional Office, during an investigation of a case involving the sale of unregistered securities discovered that it was unable to get trading information from Pickard because of Pickard's confused records and immediately notified the NYSE. In February 28, 1968, the Commission ordered a private investigation to determine

whether Pickard and/or any of its officers, directors and employees violated or caused to be violated the antifraud, broker-dealer, hypothecation and margin provision of the Securities Exchange Act of 1934.

Pickard ceased to do any new business on February 19, 1968 and the NYSE appointed a liquidator for the company on May 20.

During the months of March, April, and May 1968, hearings were held which disclosed violations by the firm, its officers, directors, salesmen and employees, of the Commission's rules and regulations relating to the extension and maintenance of credit (Regulation T), hypothecation; anti-manipulative and anti-fraud, bookkeeping and reporting requirements, from November, 1963 to May 20, 1968 when a liquidator was appointed by the NYSE. In addition, Pickard had a net capital deficiency of $746,000 as of September 30, 1967.

On August 5, 1968, the Commission ordered public proceedings to determine what, if any, remedial action should be taken against Pickard (also certain designated officials of Pickard), pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 and Section 203(d) of the Investment Advisors Act of 1940 based upon wilfull violations of Sections 5 and 17 of the Securities Act of 1933 and Sections 7(c), 8(c), 9(a)(z), 10(a), 10(b), 15(b)(1), 15(b)(5)(E), 15(c)(1), 15(c)(z) and 17(a) of the Securities Exchange Act of 1934 and Rules 8c–1, 10a–1(b), 10b–5, 15b3–1, 15c1–z, 15c1–4, 15c1–7, 15cz–1, 17a–3, 17a–4, and 17a–5 thereunder; and Sections 3(b), 4(c)(z), and 4(c)(8) of Regulation T promulgated by the Federal Reserve Board pursuant to Section 7 of the Securities Exchange Act of 1934.

On October 24, the Commission accepted John and Peter Pickard's offer of settlement whereby they consented to all of the allegations against them and to being barred from association with a broker-dealer or investment adviser and from engaging in the securities business.

The Commission reported that by March 31, 1969 twelve of the thirteen respondents named in the Commission order for public broker-dealer proceedings had submitted offers of settlement and had been accepted by the Commission. The firm consented to revocation of its registration and expulsion from membership in the NASD. Nine of the respondents received sanctions barring them from engaging in the securities business with the right in some cases to make application after one year for permission to re-engage in the securities business upon a showing of adequate supervision and on condition that they be employed in either a clerical or non-supervisory capacity. All of these respondents admitted to findings of wilfull violations ranging from manipulating a listed security to violations of Regulation T.

The liquidator completed the transfer out of all customer accounts by March 31, 1969 and filed a complaint against all of Pickard's officers alleging serious violations and charging them with all losses incurred as a result of liquidating the firm. All of the firm's subordinated lenders lost their total investment in excess of $2 million and the NYSE also expended certain of its funds.

In April 1969 the NYSE's role as liquidator terminated with the appointment of a receiver by the Chancery Court of Delaware to supervise the remaining details of the liquidation.

Appendix B-37

L. D. POLYCARPO COMPANY

L. D. Polycarpo Company became registered with the Commission as a broker-dealer on October 28, 1962. Polycarpo's office was located in South Dartmouth, Massachusetts. It was a member of the National Association of Securities Dealers but was not a member of an exchange. It dealt principally, although not exclusively, in the sale of mutual funds.

Lionel D. Polycarpo was the sole proprietor of the firm. Prior to becoming registered, he was employed as a securities salesman with two firms from September 1960 to September 1962.

In support of his application for registration, Polycarpo submitted a statement of financial condition as of September 20, 1962. Total assets amounted to $23,800 and total liabilities amounted to $9,259. The assets included Lionel Polycarpo's residence in Dartmouth, Massachusetts valued at $17,500 with an outstanding mortgage value of $7,500. Also included in his assets was a car valued at $3,800 for which there existed a liability amounting to $1,759. The remaining assets consisted of household furniture valued at $2,000 and approximately $500 cash on hand At the time Polycarpo applied for registration, the Commission had no stated amount as a minimum net capital requirement.

Polycarpo had financial difficulties from 1965 through 1967. The firm always had bookkeeping problems according to the Commission.

On June 4, 1968, Polycarpo filed a notice with the Commission to withdraw its registration. The notice indicated that the firm owed $2,918 worth of securities to a customer. It was explained that the securities had been purchased, and that Polycarpo was waiting for delivery. No statement of financial condition was attached to the notice. As a result, an inspection of Polycarpo was undertaken by the Commission. It was revealed that the firm's books were posted only through December 31 1967, although at least seven transactions occurred in 1968. The inspection showed further that the firm's books and records were in a state of disarray and not properly preserved. The firm did not maintain the following books and records:

(1) receipts and deliveries of securities blotters,

(2) securities record for each security showing the location of all securities,

(3) memorandum of each brokerage order,

(4) copies of confirmations of all purchases and sales of securities and copies of all notices of debits and credits for securities or cash, and

(5) a record in respect of each cash account containing the name and address of the beneficial owner of such account.

The Commission also reported that an examination of the records of the Recorder of Deeds for Bristol County, located at New Bedford, indicated that two attachments had been placed against Lionel Polycarpo's home. There was no indication of the attachments in Polycarpo's records, and at first, when he was questioned about them, he denied knowledge. The Commission's further investigation disclosed the attachments were placed by the same attorney and related to two

suits filed against Polycarpo by a customer in connection with securities transactions. The first suit was filed on December 22, 1967 and the attachment was executed on December 27. The second suit was filed January 27, 1968 and the attachment was executed on January 29.

The Commission reported that the dates noted above were significant because in the notice of withdrawal the firm answered negatively in response to items 6 and 7 of the withdrawal form. These items ask whether a firm is involved in any legal action and whether there are any unsatisfied judgments or liens against the firm.[1]

The first suit was to recover damages resulting from Polycarpo's failure to promptly invest $7,510 turned over to him for investment in the Dreyfus Fund. The Commission stated that the confirmation, both in this instance and others subsequently brought to light, were not in proper form in that they were handwritten and did not disclose quantity or price per share. Delivery was not made until February 7, 1967—one year after the confirmation—and then only after several telephone calls by the attorney and after commencement of the suit. Polycarpo admitted he delayed investing the money and also stated that he "may" have used it in the meantime for his own purposes.

The second suit was based on a confirmation acknowledging the receipt of $5,000 on September 20, 1965. The confirmation stated the money was for Dreyfus Fund shares but did not indicate the amount or price per share. The attorney claims no stock at all was purchased pursuant to this transaction, but claims that the confirmation was merely a receipt for funds to be invested in the future. Polycarpo stated that the purchases were in fact made on September 16, 1965 for $2,014 and on September 22, for $2,994. Confirmations for the purchases were obtained, but the lawyer stated his client insists they were separate transactions. The Commission stated that there was no entry for the first $5,000 in the firm's books. The Commission stated on July 23, 1968 that it was unable to verify that the $5,000 confirmation represented a separate investment that was not undertaken by Polycarpo.

The Commission's investigation of four other transactions showed the following:

Charles A. Costa and his wife at Polycarpo's urging, liquidated 402 shares of United Fund on September 19, 1967. The resulting check for $7,289 was delivered to Polycarpo on or about September 29. A handwritten undated receipt was given to the Costas on one of Polycarpo's confirmation forms. The funds were to be used to purchase Dreyfus Fund shares. Dreyfus Fund's records show that the mony was not invested until January 22, 1968. The transaction did not appear on Polycarpo's records. SEC stated that he admitted the delay and again indicated the funds may have been used in the construction of his home.

Melinda C. and John Costa were approached by Polycarpo and advised to change from Fidelity Trend Fund to Dreyfus Fund. According to a confirmation dated June 8, 1967, 534 shares of Fidelity were purchased by the firm from the Costas at $31 per share. On June 15,

[1] Polycarpo listed his residence as an asset of the firm in the financial statement submitted to SEC with the application for registration in 1962.

Polycarpo sold 975 shares of Dreyfus, as principal, to the Costas at $17 per share. Dreyfus Fund's records indicated that the money was not invested until October 13, and delivery still had not been made by July 23, 1968. Polycarpo admitted he had not invested promptly, and admitted the funds may have been commingled with his house building funds.

Thomas Larsen invested $1,200 in Fidelity Fund through Polycarpo on October 7, 1967. A confirmation purportedly for the purchase, dated October 10, was mailed to Larsen by Polycarpo. No stock was delivered and when Larsen wrote to the Fund's custodian bank, he learned that as of April 5, 1968 no funds had been received. Larsen retained an attorney and received his money back, plus interest, on May 1.

Edward F. Almeida originally invested in Fidelity Trent Fund through Polycarpo in 1965. In October 1967, Polycarpo advised him to put his money in Putnam Fund. Almeida replied that he had no cash, whereupon Polycarpo advised him to liquidate his Fidelity (worth approximately $8,000). Almeida then explained that his Fidelity certificate was pledged as collateral on a loan with an outstanding balance of $1,300. Polycarpo told Almeida to meet him at the bank and that he would pay off the balance of the loan. This was done October 31. Polycarpo obtained Almeida's certificate—purportedly to liquidate it and invest it in Putnam. Almeida heard nothing further and when he called Polycarpo in December he learned the money had not been invested, although the Fidelity shares had been liquidated on November 1, and a check was mailed to Polycarpo on November 14. (Polycarpo claimed he was unable to invest in Putnam Equity Fund as sales had been closed. However Putnam Fund distributors advised that sales were not stopped to NASD members until January 26, 1968.) Polycarpo told Almeida he would reinvest the money in Fidelity, however, this order was not placed until March 18, 1968, and the check did not clear because of lack of funds. A certified check was ultimately delivered on April 18, 1968.

In addition to the foregoing, a delay in investing $6,000 on behalf of another customer was noted by SEC.

On August 6, 1968, Polycarpo was expelled from the NASD. NASD complaint listed the following reasons:

1. Polycarpo failed to conform with SEC Rule 15c3-1 in that on month ending dates in November 1967 through April 1968, his aggregate indebtedness exceeded 2,000 per centum of net capital.
2. Polycarpo made improper use of funds and/or securities of customers E. Almeida, L. Avila, C & D Costa, J. & M. Costa, R. Hillier, T. Larsen and A. Reale.
3. Polycarpo failed to make and keep curernt certain books and records required by Rule 17a-3 of the Securities Exchange Act of 1934.
4. Polycarpo violated Section 1 of Article III of the Rules of Fair Practice of the Association in that he failed to direct to customers with free credit balances a written statement with the necessary disclosures or to segregate such funds from funds used in the operation of his business.

Prior to being expelled from the NASD, a hearing setting down the above violations was held on July 23, 1968. Notice of the hearing

was forwarded to Polycarpo who failed to attend and was not represented at the hearing. Three days later a written answer was received in which Polycarpo did not deny the allegations but in mitigation offered the health of his daughter. He also stated that he did not desire a hearing. On August 2, administrative proceedings were instituted against Polycarpo based upon the aforementioned information.

On November 25, 1968, the Commission ordered that the files in the case be referred to the United States Attorney for the District of Massachusetts and to the Department of Justice with the recommendation that Polycarpo be prosecuted for violations of Section 17 of the Securities Act, Sections 10(b) and 32 of the Exchange Act, the Mail Fraud Statute (18 U.S.C. 1341) and 18 U.S.C. 1001, False Statements.

On December 13, SEC revoked Polycarpo's broker-dealer registration and barred him from association with a broker-dealer.

The case came to trial on March 9, 1970. After several hours of trial before a jury, Polycarpo pleaded guilty to two counts in the indictment. One count charged the violation of Section 17 of the 1933 Act and the other Section 10(b) of the 1934 Act. Polycarpo was sentenced to 3 months in jail on the first count and two years, suspended, on the second count.

Appendix B–38

HENRY J. RICHTER & CO.

Henry J. Richter & Co. became registered with the Commission as a broker-dealer on August 26, 1964. The firm had one office located in St. Louis, Missouri. It was a member of the Midwest Stock Exchange (MWSE) until December 1969, and of the National Association of Securities Dealers.

The first indication that Richter was having problems was on November 20, 1969, when the MWSE charged the firm and its president with a violation of their net capital rule. Richter had been in violation of the MYSE's net capital requirements, which require that aggregate indebtedness cannot exceed a firm's net capital by more than a 15 to 1 ratio, in May, June, July August and October of 1969. The MWSE disclosed that on October 14, it had imposed a penalty on the firm for admitted violations of two of its rules. As part of this penalty Richter was placed on probation for one year. The MWSE's analysis of the financial statements of the firm as of October 31 (during the period of probation) revealed that its net capital was $176,699 below requirements.

On November 19 the Commission inspected Richter's books and records to determine the firm's net capital condition. This inspection disclosed that after October 31 the persident of Richter had sold certain securities loaned to the firm and had loaned cash and additional securities to the firm. These actions had the effect of enhancing the the firm's net capital position by $176,699 thereby eliminating the net capital deficiency.

On December 15 the MWSF fined Richter $5,000 and censured its president for violating the MWSE's net capital requirements while the firm was on probation. The MWSE had warned Richter repeatedly, fined him in October and December and finally asked the firm to sell

its membership. Richter resigned as a member of the MWSE and contracted to sell its seat for $45,000.

On February 13, 1970, the Commission scheduled a conference with Richter for the purpose of discussing the Commission's net capital rule and the importance of compliance therewith. Also, the Commission subsequently pointed out to Richter its precarious financial positon in that on March 31 it has excess capital of only $1,000.

On May 22 the Commission ascertained that although net capital computations had not been prepared as of April 30, Richter had a net capital deficiency of $540,000. Consequently, the Commission advised Richter to cease trading. Subsequent investigation revealed that on May 19, 20 and 21 Richter drew checks payable to two St. Louis banks totaling $539,000, which were subsequently dishonored. The firm's checking account was overdrawn by $337,000.[1]

The Commission reported that as of April 30, 1970, Richter had assets of $3,888,000 and liabilities of $3,161,000, excluding subordinated liabilities of $1,352,000. It had an accumulated deficit of $1,380,000 and capital of $733,000.

On May 27, 1970, the Commission, based on a complaint filed by the U.S. District Court entered an order against Richter and its president, temporarily restraining them from violating section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder, and section 17(a) of the Securities Act of 1933; and restraining Richter from violating Section 15(c)(3) of the Securities Exchange Act of 1934 and SEC Rule 15c3-1 thereunder, and its president from aiding and abetting Richter in such acts and practices. The court also restrained Richter and its president from transferring or otherwise disposing of the firm's assets.

On May 29, 1970, Richer filed proceedings under Chapter X of the Bankruptcy Act, stating that the firm was insolvent and requesting that a receiver be appointed.

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SHOEMAKER & CO., INC.

Shoemaker & Co., Inc. became registered with the Commission as a broker-dealer in April, 1959. It was a member of the National Association of Securities Dealers but was not a member of a stock exchange. William R. Shoemaker was the president of the firm since its inception, was located in Oklahoma City, Oklahoma, and conducted primarily a wholesale business in over-the-counter securities, including local issues.

The NASD informed the Commission in August 1969 that it had held proceedings against Shoemaker and had fined the firm $6,000 and its president $2,500 concerning a personal trading account, violations of Regulation T and net capital deficiencies. The Commission therefore put the firm under surveillance and required it to submit financial

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[1] Another factor adding to Richter's already precarious financial position was noted in our review of another broker-dealer, Cutter & Co. In that case, an official of the Commission's Boston Regional Office received a telephone call from the NASD on May 15, 1970 informing him that Richter had attempted to make delivery of some securities ordered by Cutter but Cutter refused to accept them The securities involved were ordered between April 6 and April 21, 1970, at a value of $129,112. By May 15 value of the order declined to $45,550.

data and a net capital computation monthly. These monthly computations showed net capital deficiencies on six occasions between July 31, 1969 and February 20, 1970, ranging from $13,180 to almost $168,000.

The Fort Worth Regional Office warned Shoemaker on the net capital deficiencies as of July 31 and September 30, 1969 and informed the firm that any further violation of the net capital rule would be considered as willful. Nevertheless, Shoemaker had further large capital deficiencies in November 1969 and January and February 1970. However, Commission files do not show what actions, if any were taken in regard to the capital deficiencies noted in these months.

The Commission also found that Shoemaker had distributed at least 84,900 shares of Southwest Factories common stock, having a value in excess of $559,000 for the accounts of control persons during the period November 21, 1966 to January 23, 1970, and that the firm had bid for and purchased the stock during the period it was making the distribution. The Commission stated the stock was purchased in the personal accounts of W. R. Shoemaker and George Cole and distributed through the firm and that this ruse made detection extremely difficult.

In January 1970, the firm requested an extension of time to file its financial report as of November 30, 1969. The firm's certified public accountant providing a justification for the extension, pointed out that the number of accounts with either cash balances or securities positions had increased from approximately 700 at the previous audit date to approximately 1,600 at November 30, 1969. The audit report also explained that there had been excessive employee turnover, and that the firm was not successful in implementing programs for (1) improving control over the movement of securities and the recording of such movement in the position records, or (2) conducting periodic security counts to verify position record balances.

The Commission noted that this report was erroneous in that it showed cash in banks of $40,902 as subject to immediate withdrawal whereas the Commission found out that $40,000 of this amount was pledged as collateral for a bank loan and the bank account could not be reduced below $40,000 for any reason. The public accounting firm certifying the report did not disclose that the funds were restricted.

On February 10, 1970, the Regional Office informally got the firm to suspend all its operations except its wholesale operations. The following week, the Regional Office made an inspection of Shoemaker. The inspection detected several types of violations of the rules and regulations as discussed previously. In concluding its inspection of the firm, the Regional Office stated that it believed that many more infractions could have been brought to light, but because Shoemaker had tentatively agreed to a withdrawal of the firm's registration with a permanent bar of its president, additional work did not appear to be necessary at the time. In March 1970, Shoemaker submitted an offer of settlement.

On June 8, administrative proceedings were held wherein Shoemaker's offer of settlement was accepted and the firm was ordered to withdraw its broker-dealer registration effective August 10. The firm's president was barred for one year from the effective date of the withdrawal, without prejudice to his right to make application

after the one year to be associated with a broker-dealer in a supervised capacity.

In view of the seriousness of Shoemaker's violations and the extended period of time over which they occurred, it seems that the Commission's actions were neither adequate nor timely. In this case, the Commission did not go to court and attempt to get a restraining order or an injunction against the firm. Instead, after a period of about 10 months, the Commission accepted an offer of settlement from the firm and its president. Also, there was no indication that the NASD took any actions to restrict Shoemaker's operations during the periods the firm had substantial net capital deficiencies. There was no information in the Commission's headquarters file on the extent of customers' losses, if any, expected or actually incurred.

Appendix B-40

SIEREGA & COMPANY, INC.

Sierega & Company, Inc. became a registered broker-dealer with the Commission on December 9, 1966. It was a member of the Pacific Coast Stock Exchange (PCSE) and the National Association of Securities Dealers. Its principal office was located in Los Angeles, California, and it had four branch offices in California. Sierega was primarily a retail firm and a distributor for Olympus Fund.

At December 1, 1969, Sierega had an accumulated loss from operations of $237,060 which was a sizeable increase from July 31 when the accumulated deficit was $34,761. Financial difficulties reached critical proportion during the first four months of 1970. [1] Operational losses continued to mount. From December 1, 1969 to April 30, 1970, there were operational losses of $462,000 including $183,225 for the month of April alone. Therefore, by April 30 there was a total accumulated deficit of $699,060. There was also a serious deterioration in the market value of subordinated securities. On April 30, the value of such securities was about $1,330,000 whereas by May 25 the value was about $874,000, a decrease of over 30 percent. Consequently, the firm was probably insolvent at April 30 and, in fact, was insolvent on May 15 by about $400,000.

As of April 30, Sierega had an aggregate indebtedness of $2,689,047 and a net capital deficiency of $204,795 according to PCSE. The Commission computed this deficiency as $441,860. As of May 15, a PCSE computation under severe grading revealed that Sierega had a net capital deficiency of about $500,000. PCSE immediately restricted the firm's operations. On May 25, PCSE suspended Sierega because it was unable to obtain financing or otherwise overcome the capital deficiency and insolvency.

The Commission filed a complaint with the District Court on May 28 seeking to enjoin the firm from further violations of Section 10(b) of the Act of 1934 and the Commission's Rule 10b-5 thereunder, and the appointment of a receiver. The Court granted the injunction and appointed a receiver the same day. At that time Sierega had obligations to customers totaling about $2,400,000 consisting of free credit balances of $1,400,000 and securities in safekeeping of $1,000,000. The

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[1] As of December 31, 1969, Sierega had net capital of $203,679—a ratio of aggregate indebtedness to liquid net capital of 628 to 1. This was well below the maximum allowable ratio of 2,000 to 1.

receiver estimated on July 24 that there were about 5,000 creditors including customers. No estimate could be given as to the amount of customer losses anticipated.

It is not clear as to exactly why Sierega went bankrupt. Operational losses were of such magnitude that it was unable to maintain sufficient capital. However, it was not explained what caused these losses or why they reached such proportions in such a short period of time. Consequently, this case points up 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 unless there are changes in reporting requirements. On the other hand, this case points up the necessity for SIPC because there will obviously be considerable customer losses and PCSE has stated that it will not commit its trust fund to cover any part of these losses.

Appendix B–41

SNYKER, PEARSON, BROWN & CO., INC.

Snyker, Pearson, Brown & Co., Inc. became registered with the Commission March 1, 1968. The firm was a member of the National Association of Securities Dealers but was not a member of an exchange. The firm's office was located in St. Louis Park, Minnesota. As of May 14, 1969, the firm had five officers, and 19 registered representatives, one located in Las Vegas, Nevada, the remainder in central and northern Minnesota. The firm's back office staff consisted of two bookkeepers and one of the officers.

On March 19, 1969, approximately one year after inception, the firm's vice-president voluntarily telephoned the Commission's Chicago Regional Office and said that the firm discontinued business on March 13, 1969 because the depressed market in local stocks reduced the value of the firm's $400,000 inventory, which secured a $380,000 bank loan.

The Commission instituted a preliminary investigation of the firm the following day, and it was revealed that security transactions were conducted while the firm was insolvent during the last two weeks of operations. Also, customer owned securities were hypothecated. In addition, after January 1 net capital computations were not made nor did it maintain a ledger account itemizing borrowings or purchases, sales, receipts, and deliveries of securities for the firm's own accounts. The firm stated that these deficiencies were caused by carelessness on the part of an inadequate back office manager. The degree of trading activity was in excess of back office capability. Their problem was aggravated by local market reverses in late February.

On March 24, the Commission filed a complaint with the U.S. District Court and on the same date a preliminary injunction was entered alleging that the firm effected transactions in securities without disclosing that its liabilities exceeded its assets and that it was unable to meet its liabilities as they matured. Apparently, the injunction was lifted when the firm demonstrated to the Commission that it was financially able to meet its liabilities. The firm's vice-president contributed $150,000 from personal holdings and all creditors were paid in full.

The Securities Division of the State of Minnesota also suspended the license of the firm in March 1969 but reinstated it in August. However, the Division refused to renew the firm's license on January 30, 1970. When the license was reinstated in August the State imposed a condition that the firm would commence operations with net capital amounting to $100,000. Refusal to renew the license was based primarily on the fact that capital amounted to only approximately $60,000.

It was not until February 17, 1970, that the Commission's Division of Trading and Markets recommended that public proceedings be instituted against the firm. Also, it was recommended to accept the offers of settlement which, among other things, called for a fifteen (15) day suspension of the firm's registration. This was an academic exercise since the State had already suspended its license and the firm had not been operational for some months.

The fact that no losses were incurred by customers or other creditors considerably negates the importance of this case. Nevertheless, it still should be noted that the Commision made no inspection of the firm until operations were voluntarily suspended. Also, although an investigation was commenced immediately upon being informed of the difficulties and an injunction was requested in a timely manner, proceedings against the firm were not approved by the Commission until one year later and were apparently meaningless.

Appendix B-42

SUDLER & CO.

Sudler & Co. became registered with the Commission as a broker-dealer May 8, 1965.[1] Richard Kirby Hart was president and treasurer, director, chairman of the board and one of the owners of more than 10 percent of Sudler's outstanding common stock. Sudler was not a member of a national stock exchange or the National Association of Securities Dealers.

In August 1969, as a result of an inspection, the Commission found that while Sudler was not in violation of its net capital rule and was not insolvent, the firm's records reflected the following financial information:

Aggregate indebtedness	$1, 260, 000
Net capital	122, 000
Ratio (percent)	1, 027
Short security position	526, 513
Long security position	211, 190
Fails to deliver	1, 764, 000
Fails to receive	1, 184, 000

Nevertheless, in view of the short position and fail position, the Commission put the firm under surveillance by requiring a financial statement for August 31, which was received on September 18. On September 22, the Commission was advised by Sudler's counsel that he had advised the firm to cease conducting a business in securities in view of its inability to meet current demands and fulfill existing

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[1] It was the successor to Amos C. Sudler & Company.

contracts for securities sales and purchases. On September 26, Sudler filed a debtor's petition in bankruptcy in the U.S. District Court. There was no indication in the Commission's files why Sudler's counsel advised the firm to cease doing business or why Sudler filed for bankruptcy four days later.

After being informed of these events, the Commission commenced a preliminary investigation to determine whether there were any improper practices by Sudler. Among other things, it was determined that Sudler had a bank overdraft approximating $450,000, resulting in part from the practice of obtaining credit for uncollected drafts with securities attached under a security agreement with the bank, and from the issuance of checks by Sudler for incoming drafts with securities attached. In this connection, it had been found that Sudler's checks were issued to Hart in substantial amounts (as high as $50,000 to $100,000) during the month of August and the first part of September. The amounts were exactly matched by deposits on subsequent dates leading the Commission to believe the funds of Sudler were utilized by Hart for personal reasons and then returned to the firm.

The Commission found that in a number of instances, there were duplicate deliveries of securities on drafts for which Sudler received credit at the bank which would in effect bolster Sudler's cash position. In a few instances it was noted that some of the securities drafted out by Sudler were valued considerably over the market price.

The Commission also found indications that substantial unsecured accounts receivable were listed as secured accounts.

In view of the fact that its July 31, 1969 figures taken from the records of Sudler reflected a fairly strong capital position and in view of the rather sudden demise of Sudler and the questionable activities adverted to above during the months of August and September which, if found to be true, may have been used to falsely support Sudler's financial position, the Commission issued an order directing a private investigation of Sudler on October 27. This investigation was continued up through April 28, 1970 when the order was due to expire. The Denver Regional Office was not aware that on April 2, 1970 the Commission had extended the authorization for the investigation an additional six months or until October 28, 1970. On June 30, the Regional Office was carrying the investigation in a suspended category and reported that work was only to commence again if and when the formal order was extended.

It is estimated that customer losses will amount to $15,700 and losses for other broker-dealers will amount to $325,000.

Appendix B-43

SUTZ AND ROSS, INC.

Sutz and Ross, Inc., (SRI) became registered with the Commission as a broker-dealer on May 14, 1969. SRI was a member of the National Association of Securities Dealers but was not a member of an exchange. Mr. Barry Sutz was president and together with his father owned 70 percent of SRI's stock. Andrew Bryan Ross was vice-president and 10 percent share holder. Both Sutz and Ross were in

their twenties when they became registered broker-dealers and had scant experience as registered representatives with member firms. The formation of Sutz and Ross, Inc. was their first proprietary venture.

As the result of an inspection on October 25, 1969, five months after SRI's inception, NASD discovered certain deficiencies in SRI's books and records. NASD informed the Commission of the problems. SRI informed NASD that it would cease doing business until its records were currnet and accurate. Nevertheless, on October 31, the Commission commenced an inspection of the firm. This inspection revealed significant differences, inaccuracies, and a lack of current postings. For example, although the Commission's Rule 17a-3(a)(11) requires trial balances of the general ledger to be prepared currently at least once a month, SRI did not take a trial balance during the first five months of operation—a most critical period for any broker-dealer. The trial balance, as of October 10, showed imbalances totaling $470,174. The trial balance also revealed failed to deliver items of approximately $1 million but detailed accounts accounted for only $136,000 of those items. Similarly, fail to receive items were $1.5 million, but detailed accounts accounted for only $200,000 of these items.

The inspection further revealed that the following books and records were not maintained:

1. Ledgers or other records reflecting all assets and liabilities, income and expenses and capital accounts;
2. A record of the proof of money balances of all ledger accounts in the form of trial balances, a record of the computation of aggregate indebtedness and net capital;
3. Ledgers reflecting securities failed to receive and failed to deliver;
4. A record of all puts and calls, straddles, and other options in which SRI had a direct interest; and
5. A questionnaire of application for employment executed by each associated person or SRI.

The Commission inspection also revealed that a meaningful net capital computation could not be made from the books and records, but based upon the financial information supplied by the firm a total of about $52,000 was needed in order to meet the minimum net capital requirement. SRI lost $18,000 as a result of having written straddles on shares of stock for a company traded on the NYSE.

In addition to all these problems, or maybe because of them, Ross disappeared with Sutz's car and $51,000 in cash which he stole from the firm. As a result of this theft, as of December 4 the net capital deficiency increased from $52,000 to in excess of $100,000. Also, it seems Ross forged a number of checks (amount not indicated).

On December 19, the Commission filed an injunction enjoining the firm from further violations of the net capital and bookkeeping provisions of the 1934 Act and also for the appointment of a receiver for the assets of the firm.

When SRI ceased operations it had approximately 600 customers. It is estimated that these customers will incur losses amounting to approximately $75,000 and other broker-dealers will lose approximately $25,000.

This case typifies the difficulties that young, inexperienced individ-

uals can get into in a short period of time as a broker-dealer. Due to lack of experience and basic knowledge of broker-dealer operations, several required subsidiary ledgers and other records were never established and maintained. The firm started business with capital of $55,000, but within less than six months it needed at least $52,000 of additional capital to meet the minimum net capital requirement.

Appendix B-44

UNION WESTERN SECURITIES CORPORATION

Union Western Securities Corporation became registered with SEC as a broker-dealer on August 7, 1966. Union Western was a member of the National Association of Securities Dealers but was not a member of a stock exchange.

SEC had Union Western under capital surveillance from February 1967 through March 1970 because of the firm's policy of underwriting low-priced speculative securities and its practice of increasing subordinated capital for an underwriting and then, upon selling the offering, reducing the subordinated capital. SEC's surveillance consisted of reviews of financial data which it required Union Western to furnish monthly. Except for December 1967 when about $7,000 of additional capital was required, Union Western was in compliance with the net capital rule during this period. Union Western also had a record of a large amount of fails to deliver over 40 days old which the firm attributed to difficulty with another firm performing its accounting services.

The public accounting firm in certifying Union Western's financial report as of November 30, 1969 stated that certain internal controls were deemed inadequate and material in the circumstances. Bank accounts were not reconciled for extended periods of time, details of open fails balances in subsidiary records were not in balance with related control accounts, and fully paid securities were not segregated for the accounts of customers and officers. These same deficiencies were stated in Union Western's financial reports for 1967 and 1968.

On May 15, 1970, Union Western voluntarily ceased to conduct a securities business and on May 27 filed a petition for arrangement under Chapter XI of the Bankruptcy Act. On June 30 the firm applied to dismiss the Chapter XI proceedings stating it would obtain new subordinated capital, amount not stated, which would enable it to (1) return all customers' securities, or if the securities were not on hand it would purchase them in the open market, and (2) distribute all cash balances owed to customers.

There was no indication in the files that the NASD or SEC took action on the material inadequacies in internal controls and recordkeeping that occurred during 1967, 1968 and 1969. Also, there was no indication in the files of any operating restrictions being placed on Union Western because of the speculative nature of its business. The only information at the SEC headquarters office for this broker-dealer was some files at the GSA Federal Records Center containing information up to January 1968. We obtained the limited amount of information contained here at the SEC Los Angeles Branch Office.

Appendix B–45

UNIVERSAL SECURITIES CORPORATION

The Universal Securities Corporation (USC) became registered with the Commission as a broker-dealer on November 6, 1962. USC conducted a general securities business in both listed and over-the-counter securities. USC was a member of the National Association of Securities Dealers, but was not a member of a stock exchange.

USC had no recorded difficulties from the time of registration (November 1962) until mid-1968. At that time USC installed a new president and secretary-treasurer. The new president indicated that he had been a registered representative since September 1965 with four different security firms prior to joining USC as a registered representative in January 1968. His primary experience was as a beauty shop owner. The fact that he was employed by four different firms in a period of less than two and one-half years is probably indicative of questionable and/or unsatisfactory performance and it would have behooved the Commission to ascertain the opinions of the former employers as to his qualifications as a registered representative. Although there is no indication that this was done, the Los Angeles Branch Office (LABO) of the Commission did state that it had certain reservations regarding the new president because of his previous participation in what was termed as "shady deals."

Immediately after the change in management, USC's market strategy changed from conservative to very speculative. LABO indicated it was alert to USC's changes in personnel and market strategy and kept close surveillance over operations. However, there is no indication as to how this surveillance was manifested or as to its effectiveness.

The Commission's first indication of difficulties was a letter from a customer dated September 1968 complaining of USC's failure to deliver several shares of stock purchased in July 1968. Between September 1968 and February 1969 the Commission received several other letters and telephone calls from USC customers complaining of USC's failure to deliver securities. Moreover, on February 3, the vice-president of USC wrote the Commission, NASD, and others stating that since June 1968 the president was raiding USC cash. Also, it seems that on February 8, USC issued $16,000 to the president which he used to purchase outstanding stock thereby giving him control.

In addition, on February 10, 1969, General Resources Corporation (GRC) complained to the Commission about a misappropriation of $87,000 from an underwriting offering. GRC also complained that it was unable to obtain a list of the name of purchasers because of the confusion in USC's back office.

On March 6, the San Francisco Regional Office requested standby authority to institute an injunctive action against USC and its president, enjoining them from further violations of bookkeeping requirements. The firm had failed to maintain its general ledger since November 1968 and it was therefore impossible to ascertain the firm's financial condition. This authority was not necessary because on March 11, after being given a choice by the Commission between an in-

junctive action or bankruptcy, USC voluntarily filed a petition for arrangement under Chapter XI of the National Bankruptcy Act (subsequently, the proceedings were changed to involuntary bankruptcy.) The firm was adjudicated bankrupt on October 29.

At the time the petition was filed, the assets of the firm totaled $267,234 and liabilities totaled $392,871. It is estimated that the liquidation will result in customer losses of about $73,400 and broker-dealer losses of about $52,200.

As a consequence of the Commission's findings regarding the operations of the firm prior to the filing for bankruptcy, the Commission is considering possible criminal proceedings against the president of the firm.

This case supports our contention that more strict registration requirements are necessary.

Also, it does not appear that the Commission's actions were timely or adequate. Although based on present registration requirements the Commission had no basis to preclude USC's president from becoming a registered representative, it appears that losses could have been reduced. LABO officials said that they were aware of the previous background of the firm's president and because of this the firm was put under surveillance immediately after it commenced a speculative securities business in June 1968. However, from June 1968 to February 1969, there was only one investigation made of the firm. This was a cursory investigation done by the NASD at the Commission's request and revealed nothing of any significance. Based upon the aforementioned, we believe that the seriousness of this case was evident and that the Commission should have conducted a timely and thorough inspection of the firm.

Appendix B-46

WORLD SECURITIES CORPORATION

The World Securities Corporation was originally a sole proprietorship registered with the Commission as a broker-dealer under the name of J. D. Dulaney & Associates on December 2, 1964. The firm incorporated in California as J. D. Dulaney & Associates, Inc. and became registered with the Commission on February 9, 1966. Mr. Dulaney and his wife were the sole stockholders. On December 1, 1968, the firm changed its name to World Securities Corporation. The firm was a member of NASD, but was not a member of a stock exchange. The main office was located in Laguna Hills, California and there were two branch offices in California.

The firm (1) conducted a general security business; (2) acted as a broker-dealer for its customers; (3) effected transactions in listed and over-the-counter securities;[1] and (4) sold mutual fund shares. During 1965, five percent of gross income was realized from commissions on agency transactions and 95 percent of gross income was realized from sale of mutual funds.

Apparently the firm's financial difficulties commenced early in 1969. Previously, at periodic intervals, the Commission had determined that

[1] Trading in over-the-counter securities was suspended on December 4, 1968.

adequate capital was available. At December 31, 1968, the net capital was $95,099 whereas only $20,746 was required. Also, for the year ended December 31, 1968, the firm had a net profit of $105,033, however, this profit was derived primarily from a gain on inventory of $112,500 and rent income of $21,000. Commission income was only $35,600. This reflects an entirely different type of operation from that conducted in 1965 when the primary source of income was from the sale of mutual funds. The supposition that the financial difficulties commenced in early 1969 is supported by a report filed by the California Department of Corporations in September 1969 which stated:

1. The last time that the general ledger was in balance was March, 1969;
2. No trial balances were available for the general ledger, customers' ledger, brokers' ledger, or securities ledger for the period after April, 1969;
3. The firm could only locate the bank statements for one bank account for the period March, 1969 through August, 1969. The firm had at least four bank accounts durings this time, according to the report; and
4. The balances shown on the available reconciliations could not be identified in the general ledger.

In a letter dated August 1, 1969, Mr. Dulaney stated that effective immediately no further orders were to be accepted. He further stated that all registered representative licenses with the firm had been cancelled and that the three offices would be maintained by Mark P. Kruse & Co., Inc. This latter statement, however, was not correct. In a letter dated November 6, 1969 Mark P. Kruse & Co., Inc. stated that it had not acquired nor did it have any affiliation with World Securities Corporation.

By letter dated August 29 the firm requested the Commission to terminate its registration as a broker-dealer. The Commission refused to terminate the registration because the notice had been improperly filed. The NASD notified the firm on November 6 that its request for withdrawal as a registered broker-dealer and Mr. Dulaney's request for withdrawal as a registered agent had been held up pending additional information. On December 30 World Securities Corporation filed a petition for bankruptcy. Mr. Dulaney and his wife also filed a petition for personal bankruptcy on the same day in the same court. They listed assets of $831,404 and liabilities of $968,819. The firm's petition listed assets of $40,533 and liabilities of $244,806 and contained a long list of creditors but there is no indication as to which are customers, broker-dealers, or others. Nevertheless, the receiver estimates that customers will incur losses of about $61,200 and other broker-dealers will incur losses of about $138,800.

The Commission's records are not clear as to what caused the failure of World Securities Corporation. Based on the income statement for the period ending December 31, 1968, which indicated that most income was derived from a gain on inventory, it would appear that the general decline in the market in 1969 had a devastating effect on the firm's trading for its own account. However, there also may have been some improprieties.

O