CHAPTER IX—SELF-REGULATION—FINANCIAL EXAMINATIONS AND INSPECTIONS

INTRODUCTION

All broker-dealers are under the direct supervision of the Commission. Many are also under the jurisdiction of more than one self-regulatory agency. It has long been recognized that this situation could result in an unnecessary and burdensome duplication of regulatory activities. Consequently, over the years efforts have been made to avoid this duplication by allocating regulatory responsibilities among the various agencies involved. In our opinion, this allocation of responsibility has, on the whole, worked successfully.

The NYSE and the Amex (for non-NYSE members) assume the primary responsibility for regulation of their respective members, regardless of whether they are also members of a regional exchange.[1] The regional exchanges, however, generally assume responsibility for the activities of dual members to the extent that those activities take place on that regional exchange. This is also generally true where a broker-dealer is a member of more than one regional exchange but is not a member of a primary exchange, i.e., generally the larger of the two regionals will assume the primary regulatory responsibility for the member.

Most exchange members are also members of the NASD. The NASD has responsibility for all of the activities of its members, except activities involving exempted securities[2] and, to some extent, transactions taking place on exchanges.[3] Generally, it tends to defer to the exchanges on the responsibility for the financial surveillance of members, although this is not true with respect to the smaller exchanges that are not exempt from the Commission's net capital rule. In other regulatory areas, the NASD may, in some instances where an exchange is already working on a matter of mutual concern (generally in enforcement matters), choose to defer to those exchanges, again to minimize duplication of effort.

Broker-dealers who are not members of the NASD are directly regulated by the SEC under its SECO program.[4]

Provisions of the recent SIPC Act represent a Congressional desire to allocate responsibilities. Under this legislation, the self-regulatory organizations of which a member of SIPC is a member are required to inspect or examine such member for compliance with ap-

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[1] There are ten regional exchanges. These are: Boston Stock Exchange, Chicago Board of Trade (inactive), Cincinnati Stock Exchange, Detroit Stock Exchange, Midwest Stock Exchange, National Stock Exchange, Philadelphia-Baltimore-Washington Stock Exchange ("PBW"), Pacific Coast Stock Exchange, Salt Lake Stock Exchange, and Spokane Stock Exchange. Of these, the Boston, Midwest, PBW, and Pacific Coast stock exchanges are the more active.

[2] Section 15A(c) of the Exchange Act.

[3] Article I, Section 3(c) of the NASD by-laws.

[4] This is provided by sections 15(b) (8), (9), and (10) of the Exchange Act with respect to broker-dealers who are not members of the NASD.

plicable financial responsibility rules. With respect to SIPC members who are members of more than one self-regulatory organization, SIPC is required to designate one of such self-regulatory organizations to carry out the examining and inspecting responsibility.[5] We are informed that SIPC is currently gathering information upon which to determine whether reallocation of existing inspection responsibilities should be made.

The Commission's role in this regulatory scheme has traditionally been mainly one of oversight. These responsibilities are carried out in different ways, including (1) registration with the Commission of national securities exchanges and associations; (2) inspections of the exchanges and the NASD to determine the effectiveness of their regulation; (3) the opportunity to comment on proposed rules and rule changes of exchanges and the right to review and disapprove proposed rules or rule changes of the NASD; (4) review of disciplinary proceedings of the NASD; (5) formal and informal special studies, hearings and commission-industry conferences concerning particular regulatory problems. When it is felt that self-regulatory action is or would be inadequate, the Commission proceeds by direct investigation of and proceedings against broker-dealers, primarily for violations of the registration, anti-fraud, net capital and other serious violations of the Federal securities laws.

It remains to be seen how the system of self-regulation devised by Congress in Sections 6 and 15A of the Exchange Act functioned as a mechanism for the protection of investors against loss of funds and securities by warding off broker-dealer insolvency in the 1967–1970 period.

It has been noted in earlier discussion in this report, that the financial responsibility of the broker-dealer community was the one area of public protection in respect of which Congress relied very heavily on the self-regulatory organizations.[6] The role of the New York Stock Exchange is most illustrative on this subject, since in terms of number of customers and quantities of funds and securities held for them by its members the proportion of the investing public affected by that exchange's activities heavily outweighs the remainder of the public investor spectrum.[7]

Any assessment of how well that exchange performed its functions in the area of financial responsibility must be based on the manner in which it imposed and carried out, with respect to its members, its own net capital requirements, as well as the books and records and hypothecation rules of the Commission.[8]

The discussions on these subjects in the chapter on "Management and Operational Deficiencies" [9] as well as in the chapter on "The Need

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[5] SIPA Act, Section 9(c).

[6] See the discussion on this subject in ch. I under the subcaptain of "The Regulatory Policy" in the "Introduction" of this report at pp. 21–24.

[7] For example, in 1968, The NYSE handled almost three-fourths of the dollar volume on all exchanges. NYSE 1968 Fact Book.

[8] Under Section 6(b) of the Exchange Act, a national securities exchange is required to discipline its members for violations of that act. A similar responsibility is placed on the National Association of Securities Dealers, Inc. ("NASD"), the only national securities association registered under Section 15A of that act. (Sections 15A(b) (1) and (2) of the Exchange Act.)

[9] Ch. III *supra*.

for an Early Warning System"[10] provide examples of that exchange's failure to detect in time and effectively deal with trouble spots among its membership, which the absence of currency of books and records would have foreshadowed. Of course, that exchange, like all other segments of the financial community, was taken by surprise and overwhelmed by the unprecedented succession of events in the 1967–1970 era. In recognition of the seriousness of the situation, the exchange of its own accord and at the urging of the Commission adopted a number of measures, such as a shortened workday, shortened workweek, the imposition of restrictions on sales efforts and activities for houses experiencing difficulties, the increase in the maximum amount of fines, imposition of net capital penalties for aged fails, tightening of the mandatory "buy-in" rules, adoption of rules requiring the acceptance of partial deliveries, and the like.[11]

On the subject of books and records and the question of the adherence of this exchange's members to its net capital requirements, the Commission was highly critical of the NYSE for relaxing standards, particularly in the net capital area in some precarious situations. The NYSE felt that it had a trust fund to protect customers and was justified in relaxing application of the net capital rule when it believed that to enforce it immediately would increase rather than reduce danger of exposure of customers.[12]

The NYSE Special Trust Fund ("Trust Fund") had its genesis in the aftermath of the insolvency of Ira Haupt & Co. in November 1963. Haupt incurred severe financial problems when a customer was unable to meet margin calls on commodities contracts. Substantial bank loans had been obtained by Haupt, collateralized by warehouse receipts for salad oil which were later discovered to have been forgeries. The Haupt insolvency was the first major failure of a member firm since the depression. It shook public confidence in the financial community, and accordingly, induced the intervention of the NYSE which expended $9.5 million to satisfy customers' claims. This money was subsequently repaid to the NYSE by an assessment of the membership.

At the time of that crisis, a Special Committee on Expense Recovery headed by John L. Loeb of Carl M. Loeb, Rhoades & Co. studied methods to provide funds for the NYSE to handle future emergency situations. The committee's recommendations to establish a Special Trust Fund of $10 million in cash and $15 million in lines of bank credit was approved by the NYSE membership in July, 1964. The size of the Trust Fund remained unchanged until June, 1970 when $30 million from the NYSE Building Fund was added.

Since the inception of the Trust Fund, the NYSE has consistently stated its policy that although the purpose of the Trust Fund was to provide assistance to customers of insolvent member firms of the NYSE, the use of it was within the sole discretion of the Trustees of the Trust Fund. The NYSE Constitution, Article XIX, provides that:

No member, member firm or member corporation, no customer of any such member, member firm or member corporation and no other person shall in any

[10] Ch. VI *supra*.

[11] Details of these steps by NYSE and the parallel measures taken by the NASD and other national securities exchange are contained in appendix A.

[12] The interchanges on the subjects between the Commission and the NYSE are detailed in the January 12, 1971, letter of the Commission to Chairman Staggers of the House Committee on Interstate and Foreign Commerce. A copy of that letter is attached as app. D.

event have any claim or right of action, at law or in equity, whether for an accounting or otherwise, against the Exchange, the Trustees of the Special Trust Fund, or any other person, or against the Fund, as a result of any action taken or the failure to act by the Trustees in the exercise of their discretion. Whether or not expenditures from the Fund shall be made in any particular case and, if so, in what manner, to whom and to what extent, shall at all times remain exclusively within the sole and absolute discretion of the Trustees of the Special Trust Fund.

However, during the time of the insolvencies of member firms in 1969 and 1970, the Exchange was able to assert that no customer of a NYSE member firm ever lost money because of such insolvencies.[13]

The manner in which the Exchange asserted this absolutely discretionary right respecting use of the Trust Fund is illustrated by correspondence between it and the Commission on the subject of Dempsey-Tegeler & Co. In giving consideration to the action which should be taken to protect the customers and creditors of Dempsey-Tegeler & Co., the Commission on October 29, 1969, wrote that "* * * we are desirous of learning the precise nature and extent of the Exchange's financial commitment to the customers and creditors of Dempsey-Tegeler." The Exchange responded on October 31, 1969 as follows:

As we pointed out to you last Friday, we believe that any precipitous course of action by the Commission, such as, for example, an application for the appointment of a receiver of Dempsey-Tegeler at this time, could well lead to a truly chaotic situation, having, quite possibly, serious repercussions throughout the industry and for all public investors. In our best judgment, any such action would unquestionably harm the firm's customers and other creditors by freezing the situation and preventing the pay-out of funds and securities or at least delaying that pay-out for an extended period of time. Such a course of action would also very substantially increase the slight present risk that Dempsey-Tegeler will not prove able to meet its commitments because, of course, substantial operating and administrative expenses would continue, without being offset by the generation of any income. Any precipitous action would certainly immediately terminate the availability of essential bank credit.

Finally, I might point out that the Special Trust Fund may be used only at the discretion of the Trustees to provide direct or indirect assistance to customers of a member firm in financial difficulty. The Trustees have always required that any expenditure of trust funds cease immediately upon the institution of any bankruptcy proceeding by or against the firm or upon the institution of any legal proceeding looking toward the appointment of a receiver. Also, in both the duPont, Homsey and the Haupt situations, expenditure by the Exchange of its funds to assist in the liquidation of those firms was likewise conditioned upon there being no proceeding looking toward bankruptcy or receivership.

Another example of this problem revolved around First Devonshire Corporation. Between August 18, 1970, when First Devonshire Corporation was suspended by the NYSE, and August 27, 1970, when the Commission filed an injunctive action, the Commission repeatedly sought to ascertain the NYSE's position as to what financial commitments it would make to protect the customers of this firm. The Commission wrote the Exchange on August 19, 1970, as follows:

So that we may consider what, if any, action will be required we are desirous of learning the precise nature and extent of the Exchange's financial commitment to customers and creditors of [First Devonshire Corporation]. While we understand that you might believe that it is premature at this time for the Exchange to make such a commitment, it is the Commission's view that conditions are such that we must have this information.

The reply of August 20 stated:

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[13] Report of the NYSE to Members and Allied Members entitled, "Report on Self-Regulation," October, 1970.

No financial commitment has been made by the Exchange or the Special Trust Fund to the customers and creditors of [First Devonshire Corporation.[14]]

Not satisfied with this reply the Commission again wrote the Exchange on August 21, 1970:

In view of your statement that "no financial commitment has been made by the Exchange or the Special Trust Fund to the customers and creditors of [First Devonshire Corporation)," it is imperative that we be informed as soon as possible, whether and if so, to what extent, the Exchange is prepared to make a financial commitment in the event that [First Devonshire Corporation] is unable to satisfy promptly the claims of customers for their funds and securities.

The Exchange replied on August 25, 1970, stating:

As stated in my letter of August 18, the Exchange has not made a decision in this regard. The situation [First Devonshire Corporation] as we know it has not required a consideration of what, if any, financial commitment the Exchange or Special Trust Fund might consider making. If the situation changes, the Exchange will review the facts as they exist at that time. Without knowing whether such a review will be required and without knowing what the facts might be, it would not be appropriate to speculate now on what decision might be made at some future date by the trustees of the Special Trust Fund in the exercise of their discretion as trustees.

It has been seen that, in the hope that market conditions would be restored in time for it to work out the financial problems of its members with the Trust Fund, the Exchange decided in the interest of public investor customers to keep its members afloat by relaxing its interpretations of its net capital requirements.[15] The Exchange's rationale for thus interpreting its financial responsibility rules was that, in its judgment, greater carnage would result from strict application; and that it needed time to arrange for the transfer of accounts from the troubled firms to others, which it did, constructively, by direct transfers and through mergers, while reserving its trust funds for the residual hard core liquidation situations.[16] Unfortunately, in the process

[14] During the pendency of the SIPC legislation, the Chairman of the Board of NYSE sent a telegram to Senator Javits stating that, upon enactment of SIPC, the Trust Funds would be available to the customers of First Devonshire Corporation, Robinson & Co. and Charles Plohn & Co.

[15] Some details on this subject are covered in the September 3, 1971, Statement of Irving M. Pollack before the House Subcommittee of Commerce and Finance of the House Committee on Interstate and Foreign Commerce.

[16] As of July 22, 1971, $74,000,000 which were devoted to liquidations were accounted for as follows:

	Amount	Liquidations fully or substantially completed=X
Authorized amount available, funds advanced and/or committed, as of July 22, 1971	$75,000,000	
Amott Baker & Co., Inc	1,861,000	X
Baerwald & DeBoer	900,000	X
Blair & Co., Inc	14,900,000	
Dempsey-Tegeler & Co., Inc	21,800,000	
First Devonshire Corp	4,910,000	
Fusz-Schmelzle & Co., Inc	125,000	X
Gregory & Sons	5,340,000	X
Kleiner, Bell & Co., Inc		X
McDonnell & Co., Inc	8,425,000	
Meyerson & Co., Inc	161,000	X
Orvis Bros. & Co	4,200,000	
Pickard & Co. Inc	169,000	X
Robinson & Co., Inc	1,550,000	
Total	64,341,000	
H. S. Equities, Inc. (formerly Hayden, Stone Inc)	9,800,000	
Total advanced or committed	$74,141,000	
Balance remaining uncommitted	$859,000	

Note: It may be noted that of the foregoing, 4 very large firms have still not been completely liquidated.

of reacting to one emergency situation after another, it merged one cripple into another, in some cases, or hastened the demise of a member by the sale of part of its business to another. An example of the latter is reflected in a letter dated August 16, 1971, from Donald M. Collins, the receiver of the Robinson & Co. Inc., liquidation who stated:

> . . . [T]he most important cause of the bankruptcy proceedings at Robinson & Co., Inc. was the transaction with Philips, Appel & Walden Inc. ("PAW") which resulted in a transfer to PAW of net quick assets which Robinson needed to meet in a timely fashion its obligations to customers. If the financial condition of Robinson had been such that it could afford this loss of quick assets and at the same time meet all of its obligations to customers, the PAW transaction would not have been a bad one.
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> The vice of that transaction was the parties who consented to it, i.e., Robinson, PAW and the New York Stock Exchange, did not act in accordance with existing financial realities. . .

Mr. Collins stated at a further point in his letter:

> It would be noted that the Exchange did not merely consent to the PAW transaction but threatened the Robinson company early in July with suspension if the PAW transaction did not go through by the end of the month. Apparently the Exchange knew that Robinson was a problem and that PAW appeared to be an answer to that problem, and the Exchange was so happy at this development that it did not throughly investigate whether that solution was an impossible one. Of course, the Exchange had many other problems at this time with other brokerage firms and to some extent it is understandable that they were happy to see this problem apparently disappear.

This last observation by Mr. Collins most aptly describes the then existing situation and emotional state of the NYSE.

Unfortunately, the hoped for recovery of the market and the industry did not materialize in time and the Exchange's trust funds reached the point of exhaustion.[17] It was at that juncture that the Exchange importuned Congress for the law which evolved into the SIPC Act.[18] Considering the delicate nature of the public confidence in the securities markets[19], and sensitive to the protection of public investor interests, the Commission supported the SIPC legislation which the Congress eventually enacted.

With the passage of the SIPC Act, particularly with the amendment of Section 15(c)(3) of the Exchange Act by Section 7(d) of the SIPC Act, the Commission has been granted a free hand to deal with the subjects of reserves against customer credit balances and the segregation of customers' fully-paid and excess margin securities. The Commission's weakness in that regard has been called to the attention of Congress as early as 1941.[20]

By the same token, liberal interpretation of net capital rules can no longer be justified by the need for time in which to protect customers,

[17] Hearings on 1970 Bills on Securities Investor Protection before the House Subcommittee on Commerce and Finance (Serial No. 91–67), testimony of SEC Chairman Budge at pp. 151–152. See, also H.R. Rept. 91–1613, 91st Cong., 2d Sess. (1970) p. 3.

[18] Hearings before the Senate Subcommittee on Securities on the Federal Broker-Dealer Insurance Corporations, April 16 and 17, June 18 and July 16, 1970, testimony of NYSE President, Robert W. Haack, pp. 175–179.

[19] ". . . [I]n the last few years, the public's confidence has been eroded by the widely publicized distress of many broker-dealer firms caught in the paper crunch." Lybrand Report, p. 105.

[20] Report of the Securities and Exchange Commission on Proposals For Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, August 7, 1941, House Committee Print, 77th Cong., 1st sess. (1941), pp. 28–32.

and they must again be enforced with full vigor to maintain the financial integrity of member firms.[21]

The Exchanges are accordingly free to give public investor protection, not by the use of the trust funds which are really useful only as an element in the orderly liquidation of a broker-dealer and which, as already pointed out, do not serve to make the public investor whole [22] but, rather, in terms of those protections which will provide assurance that their members will be conducting going businesses, in the course of which, the customer who has left his cash and securities with his broker, can be substantially certain to receive remittance and delivery on demand. Improved net capital requirements have been adopted by the NYSE [23]; and the Commission has proposed reserve and other protective provisions respecting the funds and securities of customers to accomplish this.[24]

Apart from the measures taken in 1968–1969 in attempts to deal with the paper work glut,[25] the self-regulatory organizations have taken some forward strides towards long term solutions.

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[21] Although the exchange will no longer maintain trust funds for reimbursing public investors with regard to insolvencies subsequent to SIPC, it is carrying out its obligations in connection with earlier liquidations. In May, 1971, $15 million were authorized for possible use in connection with the duPont Glore Forgan indemnification agreement to facilitate the new financing by the H. Ross Perot group. On July 23, 1971, a constitutional amendment was proposed to the membership to increase the Trust Fund by $20 million to $110 million for increased costs of the Blair & Co. liquidation and other unforeseen contingencies of other liquidations. The Trust Fund does not include a $30 million indemnification authorized in December 1970 to Merrill Lynch in connection with its acquisition of Goodbody & Co., comprised of $20 million for losses arising from Goodbody's bookkeeping and securities handling problems and up to $10 million for any damages resulting from litigation connected with the acquisition. On July 23, 1971, the NYSE announced that the full $20 million would be necessary but that there was presently no determination of the effect of any litigation with regard to the $10 million indemnification.

[22] 1971 Staff Report (Staff Study for the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce), Subcommittee Print, p. 4.

[23] NYSE Rule 325.

[24] See proposed rules 15c3–3 and 15c3–4 and proposed amendments to rules 8c–1 and 15c2–1 in Exchange Act release 9388, November 8, 1971.

[25] The details of the activities of the self-regulatory bodies in this period will be found in Appendix A. The activities of the NASD are summarized by it in the following "Recapitulation of what the NASD is doing and proposes to do to alleviate the problem areas" attached to its October 13, 1969, letter to the Commission:

1. We are conducting an intensive examination in cooperation with the Securities and Exchange Commission and the New York Stock Exchange aimed specifically at our non-NYSE members who have a substantial fail problem or those who we suspect have problems. In those firms where we find violations of capital positions or delinquencies in books and records we will insist on curtailment of activities until the situation is corrected.
2. We have initiated talks with the Midwest Stock Exchange and the Pacific Coast Stock Exchange with a view to expand over-the-counter clearing operations beyond those now conducted in New York City through the American Stock Exchange. We have contacted the firm of Arthur D. Little & Co. who we understand has some knowledge and experience in this field with the thought that they will help to speed this effort. We are receiving helpful cooperation from the above mentioned exchanges and also the offer of assistance from other regional exchanges.
3. Earlier this year we obtained "fails" information from our entire membership. This information has been very useful in our corrective measures.
4. We have adopted a Monthly Fail Report which will be filed by approximately 100 of our non-NYSE members who have the largest fails. We expect to have May 31, 1968, figures available soon.
5. We participated with the stock exchanges earlier in the year in shortening trading hours for two different periods of time.
6. We initiated the full-day Wednesday closings starting on June 12, 1968. We believe these have been very helpful in allowing member firms to reduce their operational difficulties.
7. We have passed new regulations allowing for delivery of stock certificates in excess of 100 shares which we expect will alleviate some delivery problems.
8. We are perfecting a comparison form which should correct a large part of the "Don't Know" problem.
9. We participate regularly in the New York Ad Hoc Committee which studies these overall problems.
10. We are actively working with the bankers' group in their C.U.S.I.P. system which will uniformly number banks and dealers and securities for future aid in automation.

The NYSE has tightened its net capital rules.[26] Similar improvements are being processed by the Amex; [27] and the Pacific Coast Stock Exchange has also substantially improved its net capital requirements.[28] The NASD, moreover, has under active consideration establishing standards for its members which are more protective in some respects than the Commission requirements under Rule 15c3-1.

In addition to the foregoing, the more significant steps taken by the NYSE include the adoption of a new rule 440.25 which expands on the books and records requirements by specifying prompt recording of receipts and payments of moneys and securities, the entry into suspense accounts of all doubtful items requiring resolution, and providing for the assignment to each bookkeeping account of a specified employee for control and oversight of entries into that account. Periodic supervisory review, not less than monthly, is also contemplated. It also adopted rules, (1) requiring monthly reporting by its members of their "fails," (2) enabling the Board of Governors to suspend members for operating difficulties, and strengthening procedural provisions for suspension of members, (3) enabling members to make public offerings of their stock, and (4) requiring members to mail financial statements, including the auditor's report, to customers on completion of an audit. In addition, its Department of Member Firms published and distributed a number of Information Circulars on such subjects as the necessity for prompt delivery of securities, the reporting of "control" stock, the segregation of securities, the maintenance of books and records, and the means for effecting partial deliveries in partial completion of COD orders.

The NASD similarly adopted new rules and disseminated information circulars on a comparable range of topics, as did the Amex which announced on June 20, 1971, that it underwent a major restructuring of its organization to make it more responsive to the needs of the day; and which, in December 1970, inaugurated a "box count" rule calling for the entry of all unresolved differences in a "securities count difference account."

Apart from the foregoing individually adopted measures, the NYSE, Amex, and the NASD jointly commissioned the Rand Corporation to undertake a study that would apply long-range planning approaches to operational problems in the securities industry. This has resulted in the comprehensive report which was discussed in the Chapter on "Handling of Certificates—Necessity For Modernization of Delivery, Clearance, and Transfer Procedures." [29] The American Stock Exchange retained North American Rockwell Corporation to analyze current operational systems and methods with the view to proposing immediate, short term solutions.

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[26] The details of the improvements are contained in the Statement of Irving M. Pollack before the House Subcommittee on Commerce and Finance, September 3, 1971. At the August 3, 1971, hearing before that Subcommittee, the NYSE asserted that under the revision, there is less room for interpretative variations than under its previous rule. Part I, Hearings on Study of the Securities Industry, pp. 139–140

[27] Joint letter of the New York and American Stock Exchanges dated August 13, 1971, addressed to Chairman Casey of the Commission.

[28] Letter July 6, 1971, from Thomas P. Phelan, President of the Pacific Coast Stock Exchange, to Chairman Casey of the Commission.

[29] Ch. VIII, *supra*, pp. 200–202.

This also resulted in a report whose contents have been discussed elsewhere in this report.[30] In conjunction with the management consulting division of the accounting firm of Ernst and Ernst, the Amex also worked in preparing a manual containing the step-by-step procedures for monitoring and controlling paperwork processing, improving customer services and planning, and brokerage firm profitability. This resulted in the inauguration of the FACS program already discussed [31] in which as of June 1, 1971, firms representing over 70 percent of the industry capacity, including the 65 largest firms, were participating.[32]

Another joint effort of the NYSE, Amex and NASD which will soon be completed relates to a standardized financial and operational monthly report form, embodying substantially all of the features now contained in their separate report forms.

The self-regulatory organizations have also taken steps to intensify their inspection and supervisory responsibilities. The NYSE now has a monthly supervisory review program.

For its fiscal year which ends on September 30, 1972, the NASD has increased its staff by 102 additional employees, 64 of whom have been assigned to the examining staffs in the NASD's 15 district offices. This means that the NASD now has 171 examiners to examine approximately 4,500 member organizations.

The NASD has announced that:

1. It is constructing a more comprehensive securities exam to qualify securities salesmen,
2. It is considering a rule which would require that at least one principal in each new member firm must qualify in a separate exam on brokerage operations, and
3. It has budgeted $68,000 in the current year for processing X-17A-10 income and expense reports and $72,000 for processing Form Q, the quarterly financial reports.

The Midwest Stock Exchange ("MSE") three years ago had 4 employees to oversee compliance with its net capital rule, to conduct examinations and to handle registration requirements. Today all self-regulatory functions other than floor surveillance have been placed in a Member Firms Division which consists of 24 persons (15 examiners, 3 directors and 6 clerical employees who have technical training). Moreover, there are 4 persons with responsibility for listing of issues and 4 people in the section dealing with the registration of salesmen. These 8 persons are not included in the Member Firms Division. In addition, 2 more persons are engaged in planning floor surveillance.

Three years ago, the Division of Member Firms of the MSE had an annual budget of about $50,000 to $70,000, while presently this department has a budget of about $420,000.

The industry is also participating in the BASIC (Banking and Securities Industry Committee) efforts to expedite securities transfers and banks handling of deliveries for their clients.

Mention has already been made of the very comprehensive Lybrand Report.[33]

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[30] See ch. VIII, *supra* at pp. 176–184.
[31] See ch. III, *supra* at pp. 121–122.
[32] Amex, June 1, 1971, Report at pp. 37, 39–43.
[33] Chapter VIII, *supra* at pp. 191–193.

From all of these have come suggestions regarding computerization, a machine readable certificate, and the immobilization of the stock certificate, principally through the medium of a central depository or the creation of a certificateless society through the elimination of the certificate. All of these have been mentioned previously in this report.[34]

Under Section 5(a)(1) of the SIPC Act a self-regulatory organization must, as part of an early warning system, notify the Commission and SIPC whenever it is aware that a member is approaching financial difficulty.

CONCLUSION ON SELF REGULATION

Self-regulation has worked, but not well enough. The events of the past three years have demonstrated this. Self-regulation should not be replaced, but it should be improved.

After considering the alternatives of more pervasive government regulation or self-regulation, Congress recognized that self-regulation was a desirable recourse because the sheer magnitude of the job of securities regulation precluded direct, governmental controls in all aspects.[35] Congress also recognized that self-regulatory agencies might act with less diligence than would the Government. Its solution was self-regulation supervised by the Government.

The self-regulators do have a genuine interest in effective regulation. The bankruptcy of one brokerage firm directly affects the financial and operational condition of other firms and the public image of the entire industry. It is to the advantage of everyone concerned that self-regulation prevent this from happening.

In this regard, the Special Study concluded in 1963 that self-regulation was particularly effective in the areas of financial responsibility and the maintenance of books and records. Indeed, the Special Study suggested that greater surveillance responsibility be allocated to the self-regulatory authorities in these areas. However, this conclusion was based upon conditions as they existed in the securities industry at that time. Generally, whatever financial or operational problems did arise were of an isolated nature, and the self-regulatory authorities were able to effectively handle these problems as they occurred.

The operational and financial difficulties of the past three years however, were of a scope and magnitude not encountered by the Special Study. The self-regulatory supervision that worked when one or only several broker-dealers encountered difficulties faltered when the problems became industry-wide. It became apparent that more comprehensive regulatory controls were needed—such as better reporting, early warning systems, and better settlement and clearance procedures.

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[34] Chapter VIII.

[35] In discussing the alternatives at the time of adoption of the Maloney Act amendments providing for national securities associations, the Senate Report said: "The first [alternative of increased government regulation] would involve a pronounced expansion of the . . . Securities and Exchange Commission; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase in the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation of business conduct by law. It might very well mean expanding the present process of registration of brokers and dealers with the Commission to include the proscription not only of the dishonest, but also of those unwilling or unable to conform to rigid standards of financial responsibility, professional conduct, and technical proficiency. The second of these alternative programs, which the committee believes distinctly preferable to the first, is . . . cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation." S. Rept. No. 1455, 75th Cong., 3d Sess. 3–4 (1938).

And it became clear that the existing self-regulatory apparatus was not geared to meet this situation.

However, self-regulation was not completely ineffective during this period. Deficiencies did become painfully apparent, but the fact is that the situation could well have become much worse if it were not for the efforts of the self-regulators. Certainly, the Commission with its limited resources could not have done the job alone and a major disaster was averted through the combined efforts of the Commission and the self-regulatory agencies. For example, the NYSE alone made available a total of $140 million to cover customers' claims.[36]

In the Commission's opinion, nothing has happened that demands that self-regulation be replaced by Government regulation. It is more true now than in 1934 that the sheer magnitude of the task of regulation necessitates self-regulation. It is obvious that for the Government to undertake complete, direct regulation of the securities markets would require drastic increases in money and manpower.

On the other hand it is manifest that more effective governmental action is necessary, whether it be called governmental oversight or more governmental regulation. In this connection the Commission's capacity to engage in oversight activities is being strengthened in order for it to engage in much more vigorous exchange and NASD inspection programs. The Commission is endeavoring to enhance its capability to review the financial reports and inspect the operations of broker-dealers more frequently and more intensively. As noted in various parts of this report at pertinent points the Commission has been acting on several fronts. It adopted a rule requiring broker-dealers to conduct a quarterly box count of all securities in their possession and to verify securities not in their possession over thirty-days old. It adopted a rule requiring a broker-dealer immediately to notify the Commission and any self-regulatory organization of which it is a member of a net capital violation and to file periodic reports with the Commission on any such self-regulatory organizations when its recorded net capital ratio exceeds 1200 percent or when its books and records are not current. It has published for comment proposals to increase capital requirements for entry into the business and to require a more conservative level of liquidity during the first year of a new firm's operation. It has proposed rules requiring the protection of customers' credit balances and securities. It is working on measures to establish adequate operational and financial controls respecting persons desiring to enter the business. And it has proposed a set of rules which would require broker-dealers to furnish customers with periodic reports on their financial and operational condition.

A suggestion has been made for the creation of one overall self-regulatory organization.[37] The notion that a single organization could be representative of and a spokesman for the hydraheaded securities community appears to present an oversimplified solution to a very

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[36] It must also be recognized that while the financial and operational condition of broker-dealers is a major concern of the self-regulatory agencies, they have other significant responsibilities. The administration of trading markets and market facilities, fair dealing with customers of broker-dealers, and other measures relating to the integrity of the marketplace and their members are also important areas of self-regulatory responsibility. Self-regulation has made valuable contributions in these areas.

[37] Cary and Werner, "Thinking Ahead—Outlook for Securities Markets" Harv. Bus. Rev. July–Aug. 1971, p. 16.

complex sets of facts.[38] The primary reason advanced for creating such a new self-regulatory entity is that it could coordinate the activities of the existing self-regulators, ameliorate differences between them and generally provide unified direction. However, the existing self-regulatory bodies, with direction from the Commission, can achieve as much cohesion and direction as presently organized, as they could through the offices of a parent organization. Whatever differences exist between the various exchanges and between the exchanges and the NASD cannot be resolved any more easily by interposing a new entity between the Commission and the existing self-regulatory agencies. In fact, the creation of any such entity might well have undesirable results so far as the Commission's relationship with the industry is concerned. It would create another layer of insulation between the Commission and the broker-dealer community, which would only make its oversight responsibilities more difficult to carry out.[39] Instead, it is the Commission's view that with additional funds, it will be better able to commence more vigorous exchange and NASD inspection programs and to review the financial reports and inspect the operations of broker-dealers more frequently and more intensively.

Specifically, the Commission has established an Office of Chief Examiner in the Division of Trading and Markets to coordinate on a nation-wide basis the broker-dealer and investment adviser examination program. The duties of such office will include: developing examination policies, recommending new rules and regulations relating to the program, training and coordinating the hiring of new examination personnel, coordinating multi-regional examinations and examinations involving the states and self-regulatory organizations, reviewing results of examinations to assure inspections are being effectively carried out and are consistent with policies, and preparing and maintaining a broker-dealer examination manual.

The additional personnel requested by the Commission, will enable the Commission to examine promptly the various operational and financial reports, (X–17A–5, X–17A–10, etc.) and to follow through by conducting inspections and inquiries of those firms whose reports suggest they are in or on the verge of financial difficulty. The additional personnel will permit a prompt and full review of reports, including the reports which are submitted by member firms of the NYSE. Under present policy, the latter are examined only when there is "cause" to suspect that such firms have financial difficulties.

With respect to the Commission oversight of the self-regulatory organizations, the additional manpower and other resources will be used to increase both the number and depth of on-site inspections.

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[38] Virtually every member of every exchange, apart from specialists and floor traders are members of the NASD. However, through the transparent umbrella of that organization are fragmented interests in the form of separate, virtually autonomous committees representing separate and independent segments of the industry. The industry committees of the NASD include, among others: Investment Companies Committee, Foreign Securities Committee, Trading Committee, Variable Contracts Committee, Oil and Gas Committee, Real Estate Committee and Corporation Finance Committee (re underwritings). The Committees are, in the main, chaired by a Board member, and the membership is comprised of Board members and representatives of the particular segment of the industry with which the Committee is concerned.

[39] At the time of the SIPA legislation consideration was given to making SIPC a type of self-regulatory organization but the idea was rejected.

To render self-regulation more effective, moreover, the Commission's oversight capacity has to be increased; and its authority should be strengthened to include direct power on such matters as (1) the disapproval or alteration of any rule or proposed rule of a national securities exchange; (2) the review of the disciplinary proceedings of exchanges to reverse the dispositions, modify the sanctions and remand matters for further proceedings, and (3) the enforcement of the rules of the exchanges and the NASD.[40]

[40] This is the kind of authority which the Commission has sought with regard to exchanges as far back as 1941. SEC Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, House Committee Print, 75th Congress, 1st sess. (1941), pp. 38–39.

APPENDICES

APPENDIX A—THE OPERATIONAL CRISIS

INTRODUCTION

The operational crisis and the response from the securities industry and the regulatory community reflected on the part of the self regulatory organizations an initial assumption that the difficulties were merely temporary;[1] and, that, if the clerks could only "clear up" the backlog with a little extra effort (perhaps facilitated by minor revisions in the hours of trading and delivery time), the entire situation would be resolved once and for all.[2] However, by the spring of 1968, there was growing recognition that the systems for processing transactions, both industry wide and within individual firms, had major inadequacies at the level of trading which could reasonably be expected to continue; and that, without rather drastic measures, certain firms would be unable to survive. The basic reaction then was to undertake such minor changes as appeared necessary on an emergency basis to permit the industry to continue to function while more long range industry wide solutions began to be studied.[3] By the summer of 1969 the industry had implemented many short term measures which had been conceived and fashioned in the earlier period.[4]

Nevertheless, a number of individual firms continued to be unable to meet the demands placed on them at the prevailing levels of activity and in a significant number of cases deterioration continued in spite of the measures taken to turn the situation around. At the same time, the spring of 1969 saw the beginning of the bear market which resulted in a financial crisis which embraced not only those firms whose difficulties had been recognized during the earlier period but also some others whose weaknesses had not yet become apparent.[5]

THE OPERATIONS CRISIS

The operations crisis in the securities industry first reached major dimensions in August of 1967. Newspaper reports of that period recall the feverish efforts of the Wall Street community to keep up with each day's business: Stock certificates and related documents were piled "halfway to the ceiling" in some offices; clerical personnel were working overtime, six and seven days a week, with some firms using a second or even a third shift to process each day's transactions.[6]

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[1] In 1964, average daily volume was 4.9 million shares. In 1966, it was 7.5 million shares. By 1967, it was 10.1 million shares. NYSE, 1964, 1966 and 1967 Fact Books.

[2] See New York Times, August 13, 1967, pt. III, p. 1, col. 1; Wall Street Journal, August 28, 1967, p. 11, col. 3.

[3] The NASD retained Arthur D. Little, Inc., in the summer of 1968, to conduct a study of the causes of "fails" in the over-the-counter market and to develop recommendations for measures to reduce the incidence of fails. As noted in the body of this report, Lybrand, Ross Bros. and Montgomery conducted an over all study of the industry directed to questions relative to the need for the retention of the stock certificate. The Amex retained Ernst & Ernst to engage in a study of management information systems for brokerage firms. The NYSE and the Amex retained North American Rockwell to do a "plumbing study"—a systems analysis of the factors which clog the pipes of securities transactions; and, with the NASD, they employed the Rand Corporation to develop a simulation model to assist in evaluating the impact of various proposals for revising procedures. See pp. 200–202 of this report.

[4] For example, in June, 1969, all markets were closed on Wednesdays. This practice continued for six straight months. For the next year, the regulatory community continued to focus on the number of hours per day during which the markets should remain open, the assumption being that, if hours of trading were modified, conditions would improve because volume would be reduced and firms would have more time to process transactions.

[5] The financial crisis is the subject of discussion in the subsections of this Report under the heading of "Inadequacy of Management."

[6] See Wall Street Journal, August 4, 1967, p. 2, col. 3, August 7, 1967, p. 5, col. 1, August 11, 1967, p. 1, col. 6.

Hours of trading on the exchanges and over the counter were curtailed to give back offices additional time after the closing bell.[7] Deliveries to customers and similar activities dropped seriously behind, and the number of errors in brokers' records, as well as the time required to trace and correct these errors, exacerbated the crisis.

In August of 1967, Chairman Staggers of the House Interstate and Foreign Commerce Committee wrote Keith Funston, the outgoing President of the New York Stock Exchange, asking him the reasons for the then heavy volume and the measures taken by the exchange to provide increased protection for investors during the previous 6 years. In his reply, Mr. Funston took the position that the two subjects were quite distinct. Following extended discussion of the high volume which he attributed basically to overall growth in the size of the economy and the increase in the number of public investors and the activities of institutional investors, Mr. Funston made two observations about the significance of the increased volume: First, that, although the exchange's planning and development studies made over the past ten years did not indicate that present volume would be reached until the mid 1970's, the exchange had taken various steps to enable the exchange to cope with the upsurge of activity "without any serious problems in the market place"; and secondly, that he did not envision a recurrence of the disproportionate participation by small unsophisticated investors against which he had cautioned in 1961.

In describing steps taken for further investor protection, he discussed the major investor protection activities of the exchange by reference to each exchange department. He noted, for example, the fidelity insurance program of the Department of Member Firms, the special trust fund of $25 million, and the spot checking of supervisory practices of all sales offices at least every third year. The letter did not discuss the ways the exchange was equipped to cope with operational or financial difficulties that may be encountered by members firms, except to refer to the trust fund and mention that the accountant examiners conduct annual surprise reviews of the back office records of specialists and floor traders (neither of whom do business with the public). The letter was sent on August 23, 1967, a time when the exchange was doing business on a shortened workday—to allow back offices a chance to catch up, as previously indicated. As of the beginning of 1967 there was no official estimate of the industry's capacity to process and accordingly no statistics were kept to determine how close to capacity the industry might be actually working. As a result, indications that capacity had been exceeded came in such crude and belated indicators as letters of complaint to the individual firms, the securities exchanges, the Commission, and members of Congress.[8]

The industry's initial response to these first indications of trouble was several fold: at the individual firm level "back office" employees were hired in greater numbers, and clerical forces worked 6 and 7 day weeks, in multiple shifts, for an extended period.[9] The rate of turnover increased faster than total employment during this period because of "raiding" between firms for experienced personnel.[10] At the New York Stock Exchange an "Ad Hoc Operations Committee" was established, and the Exchange began to collect weekly fails statistics from a sample of key firms. In November of 1967, President Ralph Saul of the American Stock Exchange made the first of a number of speeches in which he attempted to outline the long range significance of the conditions that the industry was attempting to deal with.[11]

These events were not altogether unexpected. During 1966, the Commission's Division of Trading and Markets experienced a marked increase in the number of complaints based on such matters as delays in the delivery of securities, delays in the transmittal of funds, correction of errors in statements, and the like. The Commission wrote the chief administrative partner or officer of each of the 12 firms with the greatest number of such complaints, asking (1) what the reasons were for those problems, (2) what the firms were doing to improve the

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[7] See Wall Street Journal, August 8, 1967, p. 3, col. 1, New York Times, August 8, 1967, p. 1, col. 5.

[8] See discussion, *supra*, pp. 7 and 23, for discussion of letters of complaint, and statistics.

[9] NYSE 1968 Fact Book, p. 49.

[10] See conclusion section of ch. III, p. 120.

[11] Address before the Georgia Security Dealers' Association, September 21, 1967; Remarks at the Investment Association of New York Lecture Series, October 31, 1967.

situation, and (3) whether there was anything the Commission could do to assist in this area.[12]

Three responses conveyed the impression that the situation was not serious in view of the unprecedented volume of the previous year (1966) and the over-all level of activity at the particular firm. Of the five firms which indicated that the problems of delay were quite serious, three indicated that they felt that the situation had improved at their firms at the time of writing (early 1967). In one case the firm recognized that its problems were out of line with its position in the industry. It made major changes in the form of additional space, improved salary scales and other personnel practices, and systems modifications as the outgrowth of a major management study. That firm, however, indicated that the problems it had experienced were probably common to all brokers and dealers to a greater or lesser degree. In response to the question whether delays were occasioned because customers might be expecting delivery of their securities, when the firm, through operation of its general policies, was retaining such securities in "street name", several brokers indicated that such misunderstanding could arise in a few cases but that they would in no event constitute a major cause of delay.

Most of the firms responding had automated bookkeeping systems in which transfer and delivery instructions were coded on the order form, and appropriate transfer instruction forms automatically generated at the time of execution of the order. Seven firms indicated that in the absence of specific instructions it was their practice to hold the securities in street name for the customers; three others indicated that it was their policy to transfer and ship to the customers in the absence of instructions to the contrary; and, of these, one indicated the opposite policy was not economically feasible, in their view, in light of the segregation requirements of the NYSE. Virtually all of the firms mentioned the high volume of the previous year (1966) as a major factor in delays in delivering securities, and only one indicated that its own internal expansion policy had contributed to the excessive demands of its facilities. That firm, and six of the others, either failed or experienced substantial financial and operational difficulties within the following three years.

Other factors mentioned by the brokers as contributing to problems included personnel (shortage of experienced labor, inadequate training programs internally and industry wide, and poor working conditions); problems in internal organizations and systems (conversion to automated processing or bookkeeping was mentioned by several firms as a source of difficulty); problems with other brokers failing to deliver securities to the firm in question; difficulties of transfer (this was mentioned by almost every firm); and inadequate communications with customers to obtain and record their instructions with respect to securities transactions in a timely and accurate fashion. Most of the firms volunteered no specific suggestions with respect to the problems they had indicated. Several mentioned the need for every firm to develop its own solutions in the light of its particular situation and one (which has since failed) indicated that the Commission should avoid any hard and fast rules in this area "which might cause legitimate customers grievances on the seller's side of the market to match those of the buyer's side."

Suggestions that the Commission could be of assistance came from three brokers, including the following items:

1. Advise every corporation with securities registered under the Exchange Act that it has the responsibility to provide for the rapid transfer of its securities.
2. Support the idea embodied in the Central Certificate Service.[13]
3. Assume leadership in the area of providing for the development of different means of transferring securities and different forms of stock certificates.
4. On the subject of facilitation of transfers, solicit the support of the Stock Transfer Association, the Corporate Transfer Agents Association, the Cashiers Division of the Association of Stock Exchange Firms, the American Society of Corporate Secretaries, the national securities exchanges and the banks.

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[12] On January 31, 1967, the Commission wrote Shearson, Hammill, Merrill Lynch, F. I. duPont, Glore Forgan, Bache, Dempsey-Tegeler, Goodbody, Hayden, Stone, Reynolds & Co., Walston & Co., Weis, Voisin, Cannon and Thompson & McKinnon All but Weis, Voisin, Cannon and Dempsey-Tegeler replied to our letter at that time, although the latter firms did eventually respond.

[13] This refers to the Central Certificate Service of the NYSE described, *supra*, at pp. 187–190.

5. Support efforts to obtain uniform securities transfer acts and terminology.

Despite the legislatively dictated self-regulatory nature of the securities industry and the assertion that individual securities firms should make their own business decisions with respect to coping with the operations crisis, both of which points were stressed in the aforementioned letters, the Commission was not inactive during this period. Efforts were made by the Commission to express its concern to the self-regulatory authorities and many steps were taken directly, such as public releases and administrative proceedings, to attempt to correct the situation.

In August, 1967, the exchanges and the NASD shortened the trading day for a brief period,[14] and in January 1968, they reinstated the short day by closing the markets at two o'clock.[15] Apparently, there was still a feeling that if a few hours of hard work were put in and perhaps one or two free days to make old deliveries, the whole matter could be cleared up and everyone could get back to normal business.[16] There were two legal holidays in February and there would be one "free day" when the time period for settling transactions was extended from four days to five days with the consent of the Federal Reserve System.[17] It was anticipated that volume could be curtailed and clerical time freed up to bring the entire situation under control during those "free days." [18]

Apparently, the decision to curtail trading hours like most in the operational sphere over the next several years was generated by the securities industry Ad Hoc Operations Committee, consisting of key staff members of the New York and American Stock Exchanges and other industry representatives. When the Ad Hoc Committee was established in August of 1967, the industry began collecting fails statistics from a representative sample of exchange member firms.[19] According to the fails statistics received for the sample, fails increased in early January, 1968 to a high of fails to deliver of 1,341,133 and fails to receive of 1,588,451. It was apparently this development which triggered the decision to shorten trading hours again.

Shortened hours of trading prevailed for about 6 weeks, until March 10, 1968. Fails for the 74 firms changed during that period from:

	Fails to deliver	Fails to receive
Beginning of period	1,450,090	1,726,754
End of period	867,332	1,103,221

In that same period, the average daily trading volume in shares of companies listed on the New York Stock Exchange declined from 11,947,000 to 9,178,000. It is accordingly possible that the prime motivation for resuming normal hours was the feeling that matters had been brought under control as hoped.

When the exchanges shortened hours the second time in late January of 1968, the Commission wrote[20] asking what other steps were being taken to deal with the worsening backlog.[21] President Haack's reply of February 7, 1968 enumerates the Exchanges' view of the problems and the steps which have been taken and were being contemplated to relieve the situation as of that time. The letter is informative and pertinent enough to be reproduced in full at this point.

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[14] Wall Street Journal, August 18, 1967, p. 5, col. 2.

[15] Wall Street Journal, January 20, 1968.

[16] Wall Street Journal, August 28, 1967, p. 11, col. 3; New York Times, August 13, 1967, Sec. III, p. 1, col. 1.

[17] NYSE Member Firm Circular, February 2, 1968.

[18] Member Firm Circulars, Jan. 22, 1968 (Lincoln's Birthday), Feb. 16, 1968 (Washington's Birthday); Special Membership Bulletin, March 8, 1968.

[19] Initially the sample was 79 firms; the number has subsequently been reduced to 63 by reason of merger and dissolution of component firms.

[20] Letters of similar import were sent to the NYSE, Amex, and the NASD.

[21] Letter dated January 31, 1968, from Chairman Cohen to Robert Haack.

NEW YORK STOCK EXCHANGE,
New York, N.Y., February 7, 1968.

HON. MANUEL F. COHEN,
Chairman, Securities and Exchange Commission, Washington, D.C.

DEAR MR. COHEN: As you know, the various Exchanges and their Clearing Corporations are processing volume with little or no difficulty. The industry problems are primarily reflected in the office operations of securities firms and in bank transfer operations. In answer to your inquiry, we define the office operations problems as: fourfold.

1. A severe shortage of competent and trained personnel in the industry. The Association of Stock Exchange Firms is broadly addressing this problem. In addition, several firms have inaugurated office operations training programs, and others are instituting such programs.

2. Some seven items have been identified as "Street" problems of cumbersome methods relating to techniques or controls in dealing with banks. These problems were defined as result of the Presidents Steering Committee established to collect the security industry problems relating to activities with the banks. The banks have augmented this list with problems relating to the securities industry.

The securities industry committee is composed of the New York Stock Exchange, the American Stock Exchange, the Association of Stock Exchange Firms, and National Association of Securities Dealers. Industry sub-committees comprising operations management from securities firms and a staff member from each exchange have been established to research and resolve each problem. The clearing house banks are in the process of assigning personnel to each subcommittee. The defined inter-industry problems and various sub-committee assignments of the securities industry are attached.

3. In some instances, firms have an urgent need for automation or an increased level of automation in the area of office operations. Firms are addressing themselves to this problem through use of their own computers or availing themselves of the several service bureaus offering such accounting packages.

4. The most complex problem relates to the workload of the physical handling of securities, transfers, and control of "fails". The remainder of our comments relate to action the Exchange has taken to date in attempting to relieve operations pressures, recommendations under consideration concerning "fails", and suggestions for intermediate and long term solutions pertaining to the physical handling of securities.

The New York Stock Exchange has:

1. Again and for an indefinite period resumed early closing at 2:00 P.M.

2. Through the Stock Clearing Corporations, changed the last security drop to 11:00 A.M. from Noon in order to provide cashiers with more time for balancing routines during the remainder of the day.

3. Continued to require member organizations to staff offices until 7:00 P.M. week days.

4. Modified the Exchange rule for "buy-ins" to permit "regular way" transactions.

5. Suspended trading for Monday, February 12, but required the offices of member firms to be staffed as well as providing floor coverage for trade resolvement.

6. Advocated five day settlement to the Federal Reserve, the effect of which enables more time for delivery results in always providing a weekend for every normal delivery date, and initially provides a day free of clearance on February 16, enabling firms to work on back logs that day.

The above actions have been the result of recommendations of an Ad Hoc Committee of the Board of Governors of the Exchange. Represented also at all meetings with this committee are Members of the Board and/or Officers of the American Stock Exchange, the Association of Stock Exchange Firms, and the National Association of Securities Dealers. Furthermore, this committee and industry representatives has:

1. Endorsed a suggestion of the American Stock Exchange to test a "fail clearance" system which should be available in about ten weeks, when required computer programming changes to the normal clearance system are completed.

(*a*) Under this concept, old "fails" would be submitted by firms, compared for clearance, paired off, money differences only settled, and intermediate deliveries thus eliminated. The plan eliminates work in the operations area of firms in addition to eliminating "fails."

(b) New York Stock Exchange's Clearing Corporation is cooperating in this development for subsequent use also, and it is hoped this practice may be adaptable to the National Over-the-Counter Clearing operation that is serviced by the American Stock Exchange.

(c) Hopefully, the statistics resulting from such a test will indicate elimination, by pair off of fails, to such an extent as to lead to the establishment of a clearing system whereby fails are a permanent record of the system as such new trades would be automatically paired off against any outstanding old fails on a daily and continuing basis, with only money differences settled. Again, a vast amount of office operations work would be eliminated. As envisioned, such a plan would apply to the clearing systems of both exchanges and possibly the over-the-counter clearing activity. A year might be required to accomplish this; in the meantime, "fail clearance" would be used when practical.

2. As a more immediate solution to "fails" and, in our opinion, as a practical long term necessity, three possible plans concerning new rules are to be submitted to the Ad Hoc Committee on February 14, for their deliberation and selection of one plan.

(a) In summary, the rule plans are:

1. A delivery rule governing sold securities of customers or market makers.
2. Mandatory Buy Ins.
3. Submission monthly to Self Regulatory Agencies in total of categories of aged fails over 30 days and a penalty upon the monetary value thereof.

(b) In our opinion, the adoption of a rule aimed at policing "fails" must be industry-wide. Studies of the mix of the "fail" situation indicate that listed and over-the-counter issues are inextricably interwoven and must be carefully considered in any resolution of the problem. In fact, the over-the-counter area gives every indication of bearing a disproportionately high "fail" content and trade comparison problem in relation to trading volume.

3. We have suggested to the National Association of Securities Dealers that they, in conjunction with the American Stock Exchange, provide more direct and active support to the National Over-the-Counter Clearing Corporation, in terms of more effective administration, marketing of membership participation, and resolution of procedural problems concerning contract comparison and clearing. Their action should be oriented to relief of the "Streets" workload through more membership participation, gearing the clearing system as much as possible to listed techniques in order to take advantage of proposed "fail clearance" techniques, and the possibilities of new clearance systems, toward eventual participation in the Central Certificate Service, and toward the ultimate establishment of Regional OTC Clearing Agencies operated under the auspices of Regional Exchanges but tied into the New York based National OTC Clearing and Computer complex.

In regards to the Central Certificate Service, a major policy and procedural problem has existed with respect to the banks accepting a pledge form and bookkeeping entry concerning collateral loans. These items have complete legal status, but from the viewpoint of several banks do not provide practical indemnification covering potential errors and omissions. The computer programs for Central Certificate Service have been tested and are operative. Several full days of volume have been tested through the entire clerical and computer system. Some peaking problems of clerical input indicate that full volume is not processed until an hour or so after the required deadline that is necessary in conjunction with clearing operations. Day to day operating experience will resolve part of this problem, and changes in input technique that are under consideration should rectify the balance.

In summary, urgent priority has been placed upon resolution of the remaining Central Certificate Service problems. In two to three months, we expect the limited activation phase consisting of more bulk deposits, withdrawals, transfers, dividends, etc., and firm indoctrination to commence. This limited activation phase is expected to require three months; after which, the full operation is scheduled.

In conclusion, the extent of our short and intermediate range plans and suggestions are outlined as you requested. Longer term, we expect the Industry-Bank Steering Committee to work toward the eventual elimination of the certificates, if such a concept is possible. Suggestions or recommendations of the Commission, its staff, or those offered by others will be welcomed.

Sincerely yours,

ROBERT W. HAACK.

REVISED SCHEDULE OF POSSIBLE ASSIGNMENT OF LISTED ITEMS

I. RECLAMATION AND "DK" PROBLEMS

A Committee of Banks and Brokers, co-chaired by Bill Rowan, Assistant Vice President of Chemical Bank, and Irwin Menchel of Reynolds & Co., is preparing a uniform SCC reclamation form which would be required use by Clearing Members. The Cashiers' Division has approved the form and SCC hopes to begin its use on February 5.

II. DELIVERY PROBLEMS

A. Early drops and early pick-ups by Clearing Members and Banks.
B. Earlier time for "over the window" deliveries.
C. Open bank safe deposit facilities so that Member Organizations can have early enough access to permit them to participate in "early drop" (before 8:30 A.M.) program.
D. Arrange to have ALL deliveries to various bank departments accepted through SCC rather than reject some portion for delivery "over the window" at the bank.

III. COLLATERAL PROBLEMS

A. Inform out-of-town banks and institutional accounts about need for prompt transmission of delivery instructions to help reduce the "DK" and reclamation problems.
B. Adopt procedures to permit banks' and brokers' acceptance of partial deliveries.
C. Arrange to permit earlier access to and availability of securities held as collateral in Brokers Loan Department.
D. Improve brokers' record keeping of securities backing up day loans.

IV. TRANSFER PROBLEMS

A. Uniformity and simplification of paperwork in connection with effecting transfers of securities.
B. Transfer Identity Control—Need for identification and control schemes on stock going to and returning from banks.
C. Extend time for transfer from 48 to 72 hours.

V. CREDIT PROBLEMS

A. Credit availability in times of stress. Broker call loan arrangements. Establishing lines of credit. Balance requirements.
B. Emergency bank loans to securities dealers during non-banking hours.
C. Clarification of status of Wall Street Divisions within banks.
D. Reciprocal arrangements.
E. Attempt to standardize the type of funds, e.g., federal or clearing house, used by brokers to purchase short term investments.

VI. CUSIP

A. Acceleration of development of CUSIP.
B. Use of magnetic ink identification numbers on stock certificates.

VII. GENERAL—UNASSIGNED TO PROPOSED AD HOC SUB-COMMITTEES

A. Central Certificate Service
(a) Collateral Loans.
(b) Deliveries of listed stock via bookkeeping entries between Banks' and Clearing Members' accounts.
B. Training school for operations personnel. Interest of banks.

C. Promote greater use of large denomination stock certificates.
D. Uniformity in credit checking procedure for brokerage firms.
E. Develop a long-range program to implement transfer by bookkeeping entry; e.g., customer education, legislative changes. Purpose would be to explore steps to be taken after CCS.
F. Improve handling of bonds, e.g., use larger denomination of registered bonds, inaugurate a "curb exchange" for registered bonds and a separate clearing operation for municipal bond trades.
G. Obtain brokers' cooperation re, errors in brokers' forms, late receipt thereof, failure to check and sometimes to honor due bills and the disparity of brokers' cut-off hours.

LIST OF SECURITIES INDUSTRY REPRESENTATIVES TO SERVE WITH BANK REPRESENTATIVES IN THE INDICATED AREAS

DELIVERY PROBLEMS

James J. Barbi	W. E. Hutton.
Albert Coffey	F. I. duPont.
James B. Hannan	Loeb Rhoades.
Carming Saccardi	Merrill Lynch.
Gustave Steenstra	Dean Witter.
Paul Corey	First Manhattan and Pres. Cashiers Division.

COLLATERAL PROBLEMS

Simon Gold	Asiel & Co.
John Farley	Vilas & Hickey.
Vincent Murphy	Salomon Bros.
Frank Zarb	Goodbody & Co.

TRANSFER PROBLEMS

Thomas P. Lynch	E. F. Hutton.
William Carey	Bache & Co.
Martin Torosian	Shearson, Hammill.

CREDIT PROBLEMS

Allan Gulliver	Merrill Lynch.
Milton J. Clark	Dean Witter.
James M. Hutton, IIII	W. E. Hutton.
James M. King, Jr	F. I. duPont.
Clifford Michel	Loeb, Rhoades.

CUSIP

Junius Peake	Shields.
Arthur Saber	Edwards & Hanly.
Neil See	Merrill Lynch.

THE COMMISSION'S ACTIVITIES

As to the Commission's activities on the subject of the "back office" snarl, reference has already been made to its 1967 correspondence with the twelve firms concerning which the Commission had been receiving the greatest number of complaints respecting late deliveries and payments to customers.[22] The Commission's other activities in the period were so numerous that the most feasible way to present an undistorted picture is to provide the thumbnail chronology which follows:

October 3, 1967.—The Commission amended (Release No. 34–8172) Rule 17a–5 and Form X–17A–5, effective November 30, 1967, to require, among other things,

[22] *Supra* p. 221. These firms were: MLPF&S; Walston & Co; Weis, Voisin Cannon, Inc.; Dempsey-Tegeler & Co., Inc.; Shearson, Hammill & Co.; Bache & Co.; Hayden, Stone & Co.; Francis L. duPont & Co.; Glore, Forgan, William R. Staats, Inc.; Reynolds & Co.; Thompson & McKinnon; and Goodbody & Co.

market valuations of securities positions; identifications of securities which are not readily marketable; disclosure of fails outstanding for 30 days; separate reporting of customers' fully paid securities which are not segregated; separate reporting of borrowings and accounts subject to satisfactory subordination agreements; comments of the independent public accountant on material inadequacies in the broker-dealer's accounting systems, internal controls and safekeeping procedures; confirmation by the independent public accountant on a test basis of customers' accounts without balances, securities positions or commitments, and accounts closed since the last preceding audit; verification by the independent public accountant of the computation of the ratio of aggregate indebtedness to net capital at the audit date; and review by the accountant of procedures used in making the periodic net capital computation required by Rule 17a–3(a)(11).

January 31, 1968.—Chairman Cohen wrote letters to the NYSE and Amex and the NASD, requesting a description of the measures being taken by the organizations to handle accounting, record-keeping and back-office problems to assure prompt transfer and delivery of securities. See Exhibit 3, for Cohen letter and responses.

February 9, 1968.—The Commission permitted to become effective new 5-day settlement rules. This was to give the firms an extra day to transfer stock certificates.

March 1968.—The staff actively consulted with staffs of self-regulatory agencies concerning back-office problems.

April 5, 1968.—The Commission approved a NYSE rule to obtain monthly fails reporting by members.

May 22, 1968.—The Commission instituted its own operations and back-office inquiry. The purpose of instituting this program was two-fold: (1) to obtain necessary information concerning operation and financial conditioning of all major broker-dealer firms; (2) to physically visit and inspect premises of major firms to see conditions first-hand and to alert the brokerage community of the Commission's intense interest in the problem.

June 12, 1968.—Commission instituted public proceedings against L. D. Sherman & Co. based upon the firm's back-office problems. In order to obtain speedy action the Commission made use of its suspension powers and included in the proceeding the issue as to whether the firm's registration should be suspended pending resolution of the firm's back-office problems. The Commission decided at this time that it would make use of its suspension powers to deal with the back-office cases which it anticipated it was to face in the future.

June 17, 1968.—Commission release No. 8335 announced a meeting of the Commission and the presidents of the exchanges and the NASD to discuss the back-office and delivery back-logs and cautioning all broker-dealers of their responsibilities related to the maintenance of current books and records, financial responsibility and the prompt delivery of securities and settlement of transactions. At this meeting the self regulatory agencies were asked to consider adoption of the following measures:

1. Establishment of a specific period of time within which broker-dealers must accomplish deliveries of funds and securities to customers,
2. establishment of an appropriate "hair-cut" for aged fails to deliver (i.e. fails over 30 days old),
3. periodic confirmation of aged fails (it was suggested that this would help to resolve the so-called DK's (don't knows) that were increasing at a rapid rate),
4. the making of better use of existing clearance facilities to help clear over-the-counter transactions.
5. establishment of standards for transfer agents to insure that they have the capacity to handle the functions which they perform,
6. adoption of mandatory "buy-in" procedures and under certain circumstances requiring delivery of securities at the time of the transaction,
7. establishment of broker-dealer requirements by the various exchanges and the NASD which would specifically relate to the following:

(*a*) accounting and bookeeping systems,
(*b*) number of back office personnel that are necessary to service the brokerage firm, and
(*c*) back-office supervisory personnel.

June 20, 1968.—The Commission published a summary of the aforementioned meeting (Release No. 8341), indicating that industry leaders agreed that the fundamental problem lay in the system of processing certificates through the many steps involved in settlement and completion of trades and that the interested parties are not only broker-dealers but institutions, banks and transfer agents.

June 26, 1968.—The Commission instituted an injunctive proceeding against Allied Securities Company; and private administrative proceedings against Kroeze, McLarty & Buddleson (Commission accepted settlement on December 4, 1968.)

June 27, 1968.—The Commission instituted private broker-dealer proceedings against Ferris & Co. (Member NYSE). Between June and July 1968 staff held numerous discussions with staff of NYSE, Amex and NASD to determine actions to be taken to alleviate fails and back-office problems. During course of these discussions we insisted the NASD establish inspection program similar to ours and take action against members not complying with all applicable requirements. NASD did adopt program that we recommended and we coordinated our enforcement programs.

June 28, 1968.—The Commission adopted Rule 17a–10, which requires broker-dealers to report income and expenses.

July 5, 1968—Commission instituted private administrative proceedings against Estabrook & Co., Inc. (member NYSE).

July 9, 1968—Commission instituted private administrative proceedings against Schwabacher & Co., Inc. (member NYSE).

July 16, 1968—Commission instituted private proceedings against B. J. Securities, Inc.

July 16, 1968—The Commission and staff summoned and met with its key broker-dealer personnel from each of its regional offices in order to fully explore back-office situation and implementation of inspection program.

July 19, 1968—Conferences held with representatives of NYSE and Amex for purpose of again expressing Commission concern over back-office problems. Among matters discussed was proposal to curtail member firms OTC business and mandatory buy-in rules.

July 23, 1968—Pursuant to Commission urging for NASD to develop OTC clearance facilities, NASD retained services of Arthur D. Little to make study of situation.

July 24, 1968—Commission summoned Chairman of Board of NASD in order to discuss ways and means for NASD to assist in alleviating back-office problems of its members. At this time the Commission suggested that the NASD adopt a rule to prohibit members from effecting transactions without having customers securities in hand (this rule was later adopted by NASD).

July 29. 1968—Commission issued release No. 8363 warning brokers that they were required under law to be able to consummate securities transactions promptly. This was a reiteration of statement made by Commission in release No. 6778 on April 16, 1968.

July 31, 1968—Letter from Chairman Cohen to Messrs. Haack, Saul, and Walbert suggesting measures that could be adopted to reduce volume and minimize fails. These included the following:

1. Prohibiting for an indefinite period, all promotion and other advertising (whether in newspapers or on radio or television) designed to induce customers to engage in securities transactions.
2. Prohibiting the opening of any new offices or the employment of any new salesman (some arrangement might be made to permit the replacement of salesmen who leave.)
3. Limiting other promotional and sales activities, including publication and distribution of written materials, such as market letters.
4. Prohibiting trading for firm accounts, and accounts of partners and other associated persons (including accounts in which such persons may have an interest, e.g., "hedge funds"). This restriction would not apply to bona fide market making transactions with other dealers nor to the liquidation of existing long positions and purchases necessary to cover existing short positions.

August 1, 1968.—Mandatory buy-in rules were imposed by NYSE and Amex, These rules originated with the Commission and its staff.

August 2, 1968—Commission instituted public proceedings against Pickard & Co. (member NYSE) Release No. 8373.

August 5, 1968—Commission instituted private broker-dealer proceedings against the following: Lehman Bros. (member NYSE); Auchincloss, Parker & Redpath (member NYSE); D. H. Blair & Co. (member NYSE); J. R. Timmons & Co. (member NYSE); and Kelley & Morey (member NYSE).

August 7, 1968—NASD announced that it was continuing a special examination of its members. This was specifically at staff's urging and insistence. During 1967 and 1968 full support and assistance was given to CUSIP which was endorsed by the Board of Governors.

August 17, 1968—After lengthy discussions with members of the Securities Traders Association prepared and submitted to the NASD a proposed uniform comparison form to be used by members in comparing broker-dealer trades.

August 27, 1968—Staff forwarded to NASD a draft of a proposed rule to be adopted by the NASD under which members would be prohibited from trading in securities where they had a fail in the security of over 45 days. The NASD later adopted this rule in modified form—substituting instead of 45 days the period between 60–120 days depending upon various circumstances.

August 29, 1968—Commission instituted private administrative proceedings against Winston & Co. (member NYSE).

September 5, 1968—Commission authorized injunctive action against Dalen Investments & Funds, Inc.

September 11, 1968—The Commission, the Virginia, Pennsylvania, Maryland Securities Commissions, the NASD, the PBW Stock Exchange, and the District of Columbia Public Service Commission, issued a joint release (No. 8404) focusing attention on broker-dealers to establish a more effective supervisory system in order to meet the back-office problems. Various supervisory requirements were specified in the release.

September 13, 1968—Commission issued Release No. 8405 proposing amendment to Rule 15c3–1 to provide for a haircut on fails to deliver of over 60 days (Commission adopted the amendment January 30, 1969 (Release No. 8508)). Similar rules were adopted by the major exchanges at our insistence.

September 17, 1968—Back-office people discussed at joint meeting with SEC and State Administrators of the Mid-Atlantic States.

September 25, 1968—The Commission announced a proposal to adopt Rule 10b–14 (Release No. 8413). The proposal was designed to require that issuers provide adequate transfer facilities for their securities. The release announcing this proposal stated that the inability of purchasers of securities to obtain prompt delivery of certificates not only interferes with the maintenance of fair and orderly market, but also impedes the Commission in fulfilling its regulatory functions in the maintenance of markets which are free of fraud and manipulation.

September 27, 1968—NYSE announced to its members that it was approaching time to resume 5 day trading. At Commission insistence the resumption was delayed until January, 1969 at which time instead of full trading it was resumed on shortened hours.

September 30, 1968.—Commission instituted private proceedings against Sutro & Co. (member NYSE).

October 3, 1968.—Commission instituted proceedings against A. L. Stamm (member NYSE).

October 10, 1968.—NASD announced its intention to adopt its 60–120 day nontrading rule, to become effective December 2, 1968; this rule was adopted at insistence of the Commission and drafted by its staff.

October 28, 1968.—Commission instituted private proceedings against Fleming Jones.

October 30, 1968.—The Commission devoted a full day at its regional office conference to the discussion of back-office problems.

November 4, 1968.—Commission met again with the presidents of exchanges and NASD, in view of the serious nature of the problem and the fact that prompt and effective measures for its control have not been taken by these agencies. At Commission direction a letter stressing the need for immediate action was sent.

November 5, 1968.—Commission instituted private proceedings against Transmittal Securities Corporation.

November 19, 1968.—Staff meeting with staff of NYSE to discuss back-office problems in order to better coordinate our respective efforts and for obtaining better regulation of the problems.

December 9, 1968.—Commission requested additional information from NYSE so we could evaluate the 5-day trading rules.

December 10, 1968.—Commissioner Owens in a speech before the Conn. Investment Bankers Association discussed the back-office problems and emphasized the importance for broker-dealers to meet the problems.

December 11, 1968.—Commission instituted private broker-dealer proceedings against J. P. Rahilly.

December 11, 1968.—Staff wrote a letter to Robert Armstrong of ABA calling for speedy design of a uniform comparison form.

December 13, 1968.—Chairman Cohen in a speech before the Women's Bond Club (New York) underscored the scope of back-office problems and pointed out that these conditions imposed a real risk to the investing public.

December 17, 1968.—The Commission approved Amex proposal to provide special trust fund for customers. The Amex establishment of the trust fund was at our insistence.

December 26, 1968.—Commission met with presidents of Amex, NYSE and NASD in order to discuss status of fails and ability of industry to resume 5-day trading.

December 27, 1968.—Chairman Cohen wrote to presidents of Amex and NASD requesting that they defer return to 5-day trading.

January 3, 1969.—Staff met with NASD and Arthur D. Little in order to obtain report as to status of project to establish OTC clearance facilities.

January 8, 1969.—Letter from Chairman Cohen to Ralph Saul, President of Amex, requesting information concerning any suggestions he might have for alleviating the problems and asking that we promptly be advised of all information that will assist us in evaluating resumption of 5-day trading.

January 8, 1969.—Staff visited Pacific Coast Stock Exchange to examine clearance facilities for purpose of determining possible use of them in clearing OTC transactions.

January 8, 1969.—The Commission met in Washington with the President of Midwest Stock Exchange in order to discuss ways MSE might assist in clearing OTC transactions.

January 15, 1969.—Letter from staff to NYSE stating that we would supply Exchange with all information we obtain in course of our back-office inquiry and stating that we would continue with all our programs so long as problems exist. This was in response to an early Arning letter suggesting that we try to avoid duplication by, among other things, permitting Exchange to resume supervision of its members, which we declined to do.

January 15, 1969.—NASD announced adoption of rule requiring that all transactions be consummated prior to 150 days. This announced action is a proposal as a result of one on which the staff worked very closely with the NASD a d which was adopted by it in lieu of our request that it adopt a mandatory buy- n rule.

January 22, 1969.—Conference in Washington with Thomas P. Phelan, President of Pacific Coast Stock Exchange in order to determine what PCSE could do to assist in clearing OTC transactions. Phelan advised he was going to confer with Ralph Saul on January 24, 1969 on same problem.

January 28, 1969.—Staff conferred with Michael E. Tobin (MSE) in Chicago to determine what use could be made of facilities to clear OTC transactions at which time staff suggested meeting in Washington with all major Exchanges and NASD to coordinate activities designed to establish OTC clearance facilities.

January 30, 1969.—Commission adopted amendment of Rule 15c3-1 to provide a haircut for aged fails to become effective on March 6, 1969 (Release No. 8508).

February 1, 1969.—Conference with presidents of NASD and Amex in order to explore various ways of alleviating and improving back-office conditions.

February 28, 1969.—Commission met with representatives of self regulatory organizations to discuss OTC clearing procedures (reported in Release No. 8543).

March 4, 1969.—Commission met with officials of NASD and the Investment Bankers Association (IBA) to discuss back office problems and the relationship of new issues to those problems.

March 11, 1969.—Commission meeting with staff and regional administrators on back office problems.

March 14, 1969.—Commission meeting with Amex on back office problems and studies by Ernst and Ernst, North American Rockwell and Rand Corporation.

April 7, 1969.—Commission approved extension of NASD Emergency Rule 69–2, which prevents purchase of a security in which a member has a 120 day fail to deliver or a 60 day fail and disproportionate volume of fails over 30 days.

April 14, 1969.—Commission approved extensions of NASD Emergency Rule 69–1, which permits liquidation of fails in certain circumstances.

April 17, 1969.—Commission approved extension of NASD Emergency Rule 69–4, which requires members to liquidate fails over 90 days old (the period was lowered from 120 days).

April 24, 1969.—Commission approved extension of NASD Emergency Rule 68–1, which authorizes the president of the NASD, with consent of the Board of Governors, to order early closings.

May 12, 1969.—Meeting of Commission with NYSE and Amex re: progress on Ernst and Ernst Study, North American Rockwell report and the Rand Corp. report.

May 12, 1969.—Commission approved amendments to NASD By-laws and Emergency Rules dealing with back office problems.

May 21, 1969.—Commission discussed with Division of Corporate Regulation the back office problems of mutual funds.

May 23, 1969.—Commission strongly endorsed proposed federal legislation which would make fingerprint information available to exchanges.

June 23, 1969.—Commission meeting with NYSE, Amex and NASD regarding extension of trading hours.

June 26, 1969.—Commission approved extension of hours of trading, based on assurances that back office problem would be kept under control and that customers services would be improved.

July 23, 1969.—Meeting with Amex and North American Rockwell representatives regarding progress of Rockwell report.

August 4, 1969.—Proposed Rule 15c2–10 (Release No. 8661) to provide regulatory framework for automated trading information systems.

August 27, 1969.—Commission delayed Exchange proposal to extend trading hours for 30 days to study impact of prior extension of trading hours.

August 28, 1969.—Commission permitted NYSE to announce that hours of trading would be extended to September 29, 1969.

September 9, 1969.—Commission meeting with Amex on North American Rockwell report; Amex reported improvement in its surveillance systems.

September 17, 1969.—Commission approved letter to NYSE, Amex and NASD asking what progress had been made in clearing up the back office problem.

September 24, 1969.—Commission approved further extension of hours of trading after receiving assurances that fails would not increase and that members' financial and operational conditions were improved and that the self regulatory organizations would take certain steps to restrict trading in the event volume exceeded certain levels.

November 3, 1969.—Meeting with Amex on Ernst & Ernst report.

December 11, 1969.—Meeting with staff, NYRO and NYSE, regarding fails, complaints and financial status of member firms.

December 16, 1969.—Commission meeting with Amex on operational problems, financial condition of member firms and North American Rockwell study.

January 15, 1970.—Commission approved a letter to NYSE asking for full and complete information regarding member firms in financial difficulty.

January 30, 1970.—Commission meeting with CUSIP (Committee on Uniform Security Identification Procedures).

February 4, 1970.—Commission approved a memorandum of comment on SIPC proposal for submission to House and Senate Committees.

February 24, 1970.—Commission approved NASD Emergency Rules 70–1 and 70–2, regarding fails, and approved a letter to NASD requesting appropriate action as soon as practicable to further limit fails.

February 26, 1970.—Commission published Release No. 8831 regarding public ownership.

April 2, 1970.—Commission approved letter to NYSE raising no objection to imposition of temporary surcharge and release publishing said letter (Release 8860).

April 5, 1970.—Letter to bank regulatory agencies on role of banks in back office crisis.

April 14, 1970.—Commission approved NASD Emergency Rule 70–3, which allows NASD president, with consent of the Board of Governors, to shorten trading hours.

April 15, 1970.—Commission approved Chairman's statement concerning SIPC to be presented to a subcommittee of the Senate Banking and Currency Committee.

April 21, 1970.—Commission met with NYSE re: current financial status of member firms.

April 28, 1970.—Commission approved letters to NYSE from the Director of Trading and Markets raising question whether its continued exemption from the Commission's net capital rule was justified in view of its application and interpretation of its own rule.

April 28, 1970.—Commission approved extensions of hours of trading.

April 30, 1970.—Commission approved letter from the Division of Trading and Markets to NYSE stating that no basis existed for granting relief from net capital rule to Hayden Stone, Dempsey-Tegeler or any other firm with respect to short stock record differences.

May 6, 1970.—Commission approved letter requesting current information regarding NYSE trust fund.

May 7, 1970.—Commission meeting with NYSE re: proposal to increase its trust fund by $30 million and introduce an alternative SIPC proposal.

May 13, 1970–July 15, 1970.—Commission met on numerous occasions to consider various legislative approaches for the protection of customers' accounts.

May 28, 1970.—Commission ordered inspection of Amex specialists.

May 28, 1970.—Commission approved letter to NYSE requesting its plans for protecting public customers of Dempsey-Tegeler.

June 2, 1970.—Commission approved amendment to NASD Emergency Rule 70–1 imposing restriction on members' trading when 60 day fails are 10 percent of total (formerly 20 percent), provided further steps were taken.

June 2, 1970.—Commission met with NASD to discuss current problems and SIPC.

June 3, 1970.—Commission approved letter to NYSE requesting its plans to protect public customers of Blair.

June 10, 1970.—Commission approved NASD rule requiring CUSIP number on all stocks and bonds of issuers traded by its members.

June 17, 1970.—Commission proposed Rule 15c2–11, which requires a broker-dealer wishing to make a market to have certain information regarding this issue (Release No. 8909).

June 23, 1970.—Commission approved letters to NYSE requiring prompt action with respect to Hayden Stone and Dempsey-Tegeler.

[Pages 42K L and M Intentionally Omitted.]

September 15, 1970.—Commission proposed (Release No. 8984) amendments to Rules 17a–5 and 15c3–1 to obtain current information with respect to broker-dealers which cease to be members in good standing on an exchange.

September 30, 1970.—Commission decided to intervene in Blair bankruptcy proceeding to urge that the NYSE be permitted to continue its liquidation on basis of NYSE promise to make customers whole.

October 12, 1970.—Commission met with staff to consider NASDAQ's proposed procedures for compiling volume information.

October 22, 1970.—Commission approved letter to NYSE re: proposed commission rate schedule (Release No. 9007).

November 3, 1970.—Commission met to hear staff reports on Goodbody and duPont and approved letter to NYSE concerning its administration of its net capital rule.

November 10, 1970.—Commission approved letter to NYSE raising no objection to change in NYSE constitution to provide guarantee funds for acquisition of Goodbody by MLPFS.

December 1, 1970.—Commission adopted amendments to Rules 17a–5 and 15c3–1 (Release No. 9033) to obtain current financial information with respect to broker-dealers which cease to be members in good standing of exchange.

January 12, 1971.—Commission approved letter to Chairman Staggers of House Interstate and Foreign Commerce Committee re: self-regulation.

January 28, 1971.—Commission approved letter requesting NYSE to inform the Commission on steps being taken by NYSE to protect public customers of duPont.

April 19, 1971.—Commission proposed Rule 17a–13 (Release No. 9140) which requires a quarterly box count of securities held by a broker-dealer and verification of securities not in the broker-dealer's possession.

April 20, 1971.—Commission proposed Rule 17a–11 (Release 9128), which requires reporting when a broker-dealer's net capital approaches permissible limits and immediate telegraphic notice to the Commission when a broker-dealer ceases to be in compliance with the applicable net capital rule.

June 29, 1971.—Commission held a Conference on the Stock Certificate (Release No. 9240) at which interested persons expressed their views as to how the processing of securities transactions could be expedited.

July 30, 1971.—Commission adopted Rule 17a–11 (Release No. 9268) which requires reporting when a broker-dealer's net capital approaches permissible limits and immediate notice to the Commission when a broker-dealer ceases to be in compliance with applicable net capital requirements.

August 13, 1971.—Commission proposed amendment of Rule 15c3–1 (Release No. 9288) to require minimum net capital of $25,000 and more stringent capital requirements during a broker-dealer's first year of operation.

August 26, 1971.—Commission announced hearings to inquire into the structure of securities markets (Release No. 9315).

September 13, 1971.—Commission adopted Rule 15c2–11 (Release No. 9310), which requires a broker-dealer to ascertain that certain information is available with respect to issues for which it wishes to make a market.

November 8, 1971.—Commission adopted Rule 17a–13 (Release No. 9376), which requires once each quarter a box count of securities held by a broker-dealer and verification of securities not in the broker-dealer's possession.

November 8, 1971.—Commission proposed adoption of Rules 15c3–3 and 4 (Release No. 9388), which impose restrictions on the use of customers' funds and securities by broker-dealers.

December 3, 1971.—Commission proposed Rules 17a–5 (k) through (n) (Release No. 9404), which provides for greater disclosure by broker-dealers to customers with respect to their financial condition.

December 9, 1971.—Commission proposed amendment of Rule 15b1–2 (Release No. 9411), to require applicant for broker-dealer registration to file a statement as to his sources of capital, his arrangements for conducting the business and for obtaining additional capital, if necessary.

As noted with regard to the entry for May 22, 1968, the Commission (in conjunction with the NYSE, other major exchanges and the NASD) instituted a campaign of inspection of every major firm in the United States. As the result of those inspections both the exchanges and the Commission imposed restrictions on the activities of a number of firms which were found to be far behind in their books and records, fails, and transfers and deliveries. These limitations included such matters as the curtailment of advertising, the limitation of the number of registered representatives, the limitation of the number of transactions per day, limitations on firms' trading, restrictions with respect to underwriting commitments, and the like. The mechanism employed by the Commission to effectuate these results was the institution of disciplinary proceedings which resulted in either suspension of registrations pending completion of corrective measures within a specified time or the imposition of sanctions held in abeyance for a specified limited time pending the opportunity for completion of corrective measures. The following cases represent a sample of the proceedings taken by the Commission during the period under discussion:

Auchinloss, Parker & Redpath, Release No. 8687, August 29, 1969, Registrant undertook to comply fully with Section 17 to send to the New York Regional Office within 15 days after the end of each month for 8 months a balance sheet and report of net capital, copies of all monthly reports submitted to the New York Stock Exchange, and an affidavit that the registrant's books and records are in compliance with Section 17.

Registrant agreed to notify the Regional Office and become subject to restrictions at any time it ceases to be in compliance.

Bellamah, Neuhauser & Barrett, Inc., Release No. 8911, June 25, 1970, Registrant agreed to comply with Section 17, to comply with net capital requirements, to send to the Washington Regional Office within 15 days after the end of each month for one year a trial balance and net capital computation, a copy of the Commission's short form reporting questionnaire and an affidavit to the effect that the registrant is complying with bookkeeping and net capital requirements.

James C. Butterfield, Inc., Release No. 8824, February 20, 1970, Registrant agreed to send to the Chicago Regional Office within ten days after the end of the month a trial balance and net capital computation, a copy of a reporting questionnaire, and an affidavit that its books and records are current and net capital is in compliance. Registrant undertook to notify the Regional Office and not to solicit any business whenever it is not in compliance.

B. J. Securities, Inc., Release No. 8691, September 4, 1969, Registrant agreed to send to the Seattle Regional Office within ten days after the end of each month a trial balance and net capital computation, a completed copy of the Commmission's short term reporting questionnaire, and an affidavit stating whether registrant is in compliance with the bookkeeping and net capital rules and Regulation T. Registrant agreed to notify the Regional Office and stop soliciting business at any time if not in compliance with its undertakings.

D. H. Blair & Co., Release No. 8688, August 29, 1969, Registrant agreed to send to the New York Regional Office within 15 days after the end of each month a balance sheet and report of net capital position, copies of reports required to be submitted to the New York Regional Office and an affidavit of compliance. Registrant agreed to restrict its business and notify the Regional Office if at any time it is out of compliance with its undertakings.

W. R. Cavett & Company, Release No. 8829, February 27, 1970, Registration revoked for violations of books and records, net capital, and reporting requirements, among other things.

Comprehensive Securities Company, Release No. 8364, July 29, 1968, Registration revoked for violation of record keeping and net capital requirements, among other things.

Commonwealth Securities Corporation, Release No. 8360, July 23, 1968, Registration revoked for violation of bookkeeping and net capital requirements, among other things.

Paul H. Christiansen & Co., Inc., Release No. 8784, December 23, 1969, Registration revoked for violation of bookkeeping and net capital requirements, among other things.

Disbro & Co., Inc., Release No. 8821, February 18, 1970, Registrant agreed to send to the Cleveland Branch Office within ten days after the end of each month a trial balance and net capital computation, a completed questionnaire and an affidavit of compliance. Registrant undertook to notify branch office and cease soliciting business at any time it is out of compliance with its agreement.

Dollan & Company, Inc., Release No. 8941, July 22, 1970, Registration revoked for violation of the record keeping and net capital requirements.

C. N. Davidson & Company, Release No. 8802, January 16, 1970, Registrant agreed to send the Chicago Regional Office within ten days after the end of each month a trial balance and net capital computation, a copy of the Commission's short form questionnaire and an affidavit of compliance. Registrant agreed to notify the Chicago Regional Office and to cease soliciting business at any time it is not in compliance with its undertakings.

Dunhill Securities Corporation, Release No. 8653, July 14, 1969, Registrant after violating record keeping and net capital requirements, after having been enjoined from doing so, suspended pending final determination whether registration should be revoked.

Estabrook & Co., Release No. 8838, March 11, 1970, Registrant agreed to send to the Boston Regional Office within 15 days after end of each month its statement of financial condition and aggregate indebtedness and net capital computation and a completed copy of the New York Stock Exchange Special Operations Questionnaire. Registrant agreed to notify the regional office and cease soliciting business at any time when it is not in compliance.

First American Securities Corporation, Release No. 8928, July 9, 1970, Registration revoked for violation of the net capital and bookkeeping requirements, among other things.

First Central Bond Corporation, Release No. 8832, March 3, 1970, Registration revoked for violation of the net capital and bookkeeping requirements.

Ferris & Company, Release No. 8689, August 29, 1969, Registrant agreed to send to the Washington Regional Office within 15 days after the end of each month copies of all monthly reports submitted to the New York Stock Exchange and an affidavit of compliance. Registrant agreed to notify the regional office if at any time it ceases to be in compliance.

Fleming-Jones Securities, Inc., Release No. 8513, February 5, 1969, Registration revoked for violations of the record keeping and net capital requirements.

C. H. Hendricks & Co., Inc., Release No. 8971, September 2, 1970, Registration suspended for 60 days for violation of the record keeping requirements, among other things. Registrant prohibited from resuming its broker-dealer activities until its books and records are in compliance with all applicable requirements of the Exchange Act.

Hagen Investments, Incorporated, Release No. 8859, April 3, 1970, Registration revoked for violation of record keeping requirements, among other things.

Hoit, Rose & Co., Release No. 8563, April 7, 1969, Registration revoked for violation of the record keeping requirements, among other things.

Martin J. Joel, Jr., Release No. 8956, August 13, 1970, Registration suspended for violation of the record keeping requirements, among other things.

Richard L. Kamen, Release No. 8976, September 8, 1970, Registration suspended for violation of the record keeping requirements, among other things.

Kroeze, McLarty & Duddleston, Release No. 8464, December 4, 1968, Registrant agreed to send to the Atlanta Regional Office within ten days after the end of each month trial balance and net capital computation, a completed copy of the Commission's short form reporting questionnaire, and an affidavit of compliance. Registrant agreed to notify the regional office and stop soliciting business any time it ceases to be in compliance.

Lehman Brothers, Release No. 8518, February 5, 1969, Registrant after proceedings were instituted agreed not to open additional branch offices, not to apply for additional registered representatives, not to engage in over the counter trading for its own account, not to accept odd lot orders (except if necessary to eliminate or round out customers' existing odd lot positions), not to accept orders for the purchase of securities selling at less than $5 per share, not to accept orders for short sales unless prior arrangements had been made to borrow the stocks concerned. Registrant agreed to require asurances from customers selling securities that such securities would be in its possession on the settlement date. Registrant agreed to instruct all personnel to stop the solicitation of new brokerage accounts and not to accept orders for the sale of over-the-counter stocks unless (a) the certificates were in its possession, (b) the shares were purchased through it, or (c) the order was placed by an institutional customer. Registrant agreed to use its best efforts to hold its average daily transactions (whether as dealer or broker) during each calendar week to 900 or less; and retain a firm of certified public accountants to resolve existing differences in its accounts. At the conclusion of the proceedings registrant agreed to submit to the New York Stock Exchange an affidavit of compliance. Registrant agreed further to notify the regional office and to become subject to the restrictions instituted at the beginning of the proceedings if at any time it is out of compliance with the terms of the settlement.

L. D. Sherman & Co., Inc., Release No. 8354, July 12, 1968, Registrant agreed at the institution of the proceedings to suspend all securities operations except purchases to close out existing short positions, sales from registrant's proprietary accounts to eliminate long positions, and purchases, sales or other transactions necessary or appropriate to close out existing commitments in fail accounts. Registrant agreed that it must have physical possession of each security at the time of sale, except in pair-off transactions, and agreed to make prompt delivery.

Registrant agreed further to bring its books and records into compliance and to file a certified financial statement with the New York Stock Exchange and to make no change in its corporate or capital structure without prior notice to counsel for the Division of Trading and Markets and to make no distribution except normal salaries and expenses and commissions.

May & Co., Inc., Release No. 8906, June 18, 1970, Registrant's branch office suspended from effecting transactions in the over-the-counter market for violations of record keeping requirements, among other things.

Mayflower Securities Co., Inc., Release No. 8961, August 20, 1970, Registrant suspended from underwriting activities for violation of record keeping requirements, among other things.

Lionel D. Polycarpo, Release No. 8468, December 13, 1968, Registration revoked for violation of the record keeping and net capital requirements, among other things.

Pickard & Company, Incorporated, Release No. 8433. October 24, 1968, Principals of registrant barred from association with a broker-dealer for violation of the record keeping requirements, among other things.

Pickard & Company, Incorporated, Release 8447, November 14, 1968, Registration revoked for violation of record keeping requirements, among other things.

J. P. Rahilly & Co., Inc., Release No. 8698, September 19, 1969. Registrant agreed to send to the New York Regional Office within ten days after the end of each month a trial balance and net capital computation and an affidavit of compliance. Registrant undertook to notify the regional office and stop soliciting business any time it is out of compliance.

Rowles, Winston and Company, Inc., Release No. 8519, February 5, 1969. Registrant agreed to send to the Fort Worth Regional Office within 15 days after the end of each month a trial balance and net capital computation, a completed copy of the Commission's short form reporting questionnaire and an affidavit of compliance. Registrant undertook to notify the regional office at any time it is out of compliance.

Strathmore Securities, Inc., Release No. 8207, December 13, 1967, Registration revoked for violation of the record keeping requirements, among other things.

Schwabacher & Co., Release No. 8677, August 28, 1969, Registrant was required after its merger with Blair & Co. to make a weekly report of its condition to the San Francisco Regional Office and to the New York Stock Exchange, and continue to observe the restrictions imposed by the New York Stock Exchange.

Shoemaker & Co., Inc., Release No. 8898, June 8, 1970, Registrant permitted to withdraw after violation of record keeping and net capital requirements, among other things.

Jerry R. Schreiber, Release No. 8779, December 12, 1969, Barred from association with a broker-dealer for violation of the record keeping requirements.

Snyker, Pearson, Brown & Co., Inc., Release No. 8840, March 13, 1970, Registrant agreed to send to the Chicago Regional Office within 10 days after the end of each month a trial balance and net capital computation, a complete reporting questionnaire and an affidavit of compliance. Registrant agreed to notify the regional office and stop soliciting business whenever it is not in compliance.

Stock Investors, Inc., Release No. 8827, February 26, 1970, Registration revoked for violation of the record keeping requirements, among other things.

Sincere & Company, Release No. 8916, June 29, 1970, Registrant censured for failure to comply with the record keeping requirements.

Schweickart & Co., Release No. 8955, August 14, 1970, Registrant agreed to send to the New York Regional Office within 15 days after the end of each month copies of all monthly reports submitted to the New York Stock Exchange and an affidavit of compliance. Registrant agreed to notify the regional office and to restrict its activities in terms of number of registered representatives and branch offices, solicitation of transactions and conduct of advertising as may be deemed reasonable under the circumstances. Registrant undertook to notify the branch office if at any time it ceases to be in compliance.

Sigma Securities Corporation, Release No. 8987, September 23, 1970, Registration revoked for violation of record keeping requirements, among other things.

J. R. Timmins & Co., Release No. 8690, August 29, 1969, Registrant agreed to send to the New York Regional Office within 15 days after the end of each month a balance sheet and report of net capital position, copies of all monthly reports submitted to the New York Stock Exchange and an affidavit of compliance. Registrant agreed to notify the regional office and become subject to restrictions if at any time it ceases to be in compliance.

Transmittal Securities Corporation, Release No. 8534, February 25, 1969, Registrant agreed to send to the New York Regional Office within 10 days after the end of each month a trial balance and net capital computation, a completed copy of the Commission's short form reporting questionnaire and an affidavit of compliance with the record keeping, net capital and credit requirements. Registrant agreed not to exceed a daily average of 75 orders and to notify the regional office within 3 days after the end of each week in a statement, of the average daily number of orders. Registrant agreed to notify the regional office and to cease soliciting business at any time when it is no longer in compliance.

Volante, Behar, Release No. 8932, July 16, 1970, Registration revoked for violation of the record keeping and net capital requirements, among other things.

George J. Wunsch, Release No. 8705, October 7, 1969, Registrant barred from association with a broker-dealer for violation of the record keeping requirements, among other things.

Weston and Company, Inc., Release No. 8900, June 5, 1970, Registrant agreed to suspend all conduct of securities transactions until such time as it demonstrates to the Denver Regional Office of the Commission that it has the net capital necessary to comply in all respects with the provisions of Rule 15c3–1 under the Act, except that its aggregate indebtedness to all other persons shall not exceed 1,500 per centum of its net capital, computed to the reasonable satisfaction of that Office, and it shall have a cash balance of at least $35,000, and provided further, that during such period of suspension registrant may effect liquidating transactions on a C.O.D. basis, cover its existing short positions, effect liquidating transactions of customers' existing long positions on an agency basis but foregoing commissions on such transactions, and may upon demand pay customers' free credit balances and deliver securities long in customers' accounts. The offer further provided, among other things, that registrant would continue to comply with Rule 15c3–1 and the minimum net capital and cash balance requirements set forth above, and shall within 10 days after the end of each month during the period through April 1971, submit to the Regional Office, a trial balance and net capital calculation, a completed copy of a short form reporting questionnaire, and an affidavit stating whether registrant is in compliance with bookkeeping requirements and the net capital and cash position requirements set forth above. Registrant agreed to notify the Regional Office and stop soliciting business at any time it ceases to be in compliance.

Wesco and Company, Release No. 8607, May 13, 1969, Registration revoked for violation of the books and records and capital requirements, among other things.

Woodward, Elwood & Co., Release No. 8599, May 7, 1969, Registrant agreed to send to the Chicago Regional Office within 10 days after the end of each month a trial balance and net capital computation, a completed copy of the Commission's short form questionnaire and an affidavit of compliance. Registrant agreed to notify the Regional Office and to stop soliciting business at any time that it ceases to be in compliance.

APPENDIX B

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM X-17A-5

Information Required of Certain Members, Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

GENERAL INSTRUCTIONS

A. Rules as to use of Form X-17A-5:

1. This form shall be used by every member, broker or dealer required to file reports under Rule 17a-5(*a*). It is not to be used as a blank form to be filled in but only as a guide in the preparation of the report. No caption need be shown as to which the items and conditions are not present.

2. The name of the respondent and date of report shall be repeated on each sheet of the answers and sche ;s submitted.

3. If no answer is made to a question or subdivision thereof it shall constitute a representation that respondent has nothing to report.

B. Presentation of information (including definitions):

1. The information presented shall be sufficient to permit the determination of the financial condition of the respondent.

2. The valuations of customers' securities in segregation or safekeeping need not be included in the answers.

3. Use separate pairs of columns for ledger debit and ledger credit balances; long security and spot (cash) commodity valuations and short security and spot (cash) commodity valuations; net losses in future commodity contracts and net gains in future commodity contracts. All columns must be totaled. The total of debit balances must equal the total of credit balances. The total of long security and spot (cash) commodity valuations must equal the total of short security and spot (cash) commodity valuations; the total losses and the total gains in future commodity contracts must be in agreement after consideration of "commodity difference accounts." The answers to Questions 14, 15, and 16 shall not be included in the totals.

4. Security and spot (cash) commodity valuations and losses and gains in future commodity contracts shall be based upon current market prices; fractions and accrued interest may be omitted except where such procedure in the case of short positions would have a material effect upon net capital.

5. "Securities not readily marketable" shall be so designated. The term "securities not readily marketable" shall include, but not be limited to, (a) securities, except "exempted securities," for which there is no market on a securities exchange or no independent publicly quoted market; (b) securities which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under Section 3(b) of such Act have been complied with); and (c) securities which cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the respondent.

6. All accounts (other than regulated commodity accounts) of any one customer may be combined and reported under any appropriate classification other than Question 6.A Customers' accounts related by bona fide written guarantees may be combined.

7. For the purpose of this questionnaire the term "customer" shall not include the respondent, general partners, officers, or directors. An account covered by a "satisfactory subordination agreement" shall be reported in answer to Question 12.

8. Foreign currency may be expressed in terms of U.S. dollars at the current rate of exchange and where carried in conjunction with the U.S. dollar balances

for the same customer may be consolidated with such U.S. dollar balances and the gross or net position reported in its proper classification, provided the foreign currency is not subject to any restrictions as to conversion. If the foreign currency position so treated is substantial, some indication of its size shall be given.

9. If the respondent is a sole proprietor, all accounts carried by brokers, dealers, or others for the respondent which contain money balances and/or securities allocated to or otherwise used in connection with his business shall be reported in the answers to Questions 1 through 16, as appropriate.

10. "Exempted securities" are those securities defined as such under the provisions of Section 3(a)(12) of the Securities Exchange Act of 1934 other than securities designated for exemption by action of the Securities and Exchange Commission.

11. The term "contractual commitments" shall include underwriting, when-issued, when-distributed and delayed delivery contracts, repurchase agreements, endorsements of all puts and all calls, commitments in foreign currencies, and spot (cash) commodity contracts but shall not include future commodity contracts and uncleared "regular way" purchases and sales of securities. A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

12. For the purpose of this questionnaire securities sold as principal under an agreement to repurchase shall be stated separately and clearly indicated as such in the answers to Questions 3.A. and 10.

FACING PAGE

Form X–17A–5

Information Required of Certain Members, Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a–5 Thereunder

SEC FILE NUMBER

FOR SEC USE

WORK LOCATION	DATE OF REPORT	DOCUMENT SEQ. NO.	

IAME OF REGISTRANT (*If individual, state last, first, middle name*)

I R S. Employer Identification or Social Security No.

IAME UNDER WHICH BUSINESS IS CONDUCTED (*If different*)

ıDDRESS OF PRINCIPAL PLACE OF BUSINESS

Number and Street *City* *State* *ZIP Code*

HE ATTACHED REPORT reflects the financial condition of the above registrant as of: *(Date)*

NDEPENᴗENT PUBLIC ACCOUNTANT whose Opinion is contained in this Report
Name (*If individual, state last, first, middle name*)

I R S. Employer Identification or Social Security No

Address *Number and Street* *City* *State* *ZIP Code*

Check one—

FOR SEC USE

☐ Certified Public Accountant

☐ Public Accountant

☐ Accountant not resident in United States or any of its possessions

ΓHIS REPORT CONSISTS OF (*Check below*)

☐ Part I—Financial Information

☐ Part II—Supporting Schedules

☐ Accountant's Certificate

DO NOT WRITE BELOW THIS LINE . . . FOR SEC USE ONLY

Part I

FINANCIAL QUESTIONNAIRE

Question 1—Bank Balances and Other Deposits.

State separately total of each kind of deposit (cash and/or market value of securities) with adequate description. This shall include cash on hand; cash in banks representing general funds subject to immediate withdrawal; cash in banks subject to withdrawal restrictions; funds segregated pursuant to regulations of any agency of the Federal Government, any State, any national securities exchange or national securities association; contributions to clearing organizations incident to membership; deposits with clearing organizations in connection with commitments; guaranty and margin deposits; good faith deposits (see note 3 to Question 14); drafts with securities attached deposited for collection.

Question 2—Money Borrowed, and Accounts Carried for Respondent by Other Banking or Brokerage Houses, Secured by or Containing Customers' Collateral.

State separately totals of ledger net debit balances; ledger net credit balances; long security valuations; short security valuations; spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Money borrowed:

1. From banks, trust companies, and other financial institutions

2. From others.

B. Accounts carried for respondent by other banking or brokerage houses, including omnibus accounts:

1. Securities accounts:
a. Accounts with net debit balances
b. Accounts with net credit balances.

2. Commodities accounts:
a. Regulated commodities futures accounts:
i. Accounts liquidating to an equity
ii. Accounts liquidating to a deficit.

b. Nonregulated commodities futures accounts:
i. Accounts liquidating to an equity
ii. Accounts liquidating to a deficit.

c. Spot (cash) commodity accounts:
i. Accounts with net debit balances
ii. Accounts with net credit balances.

Notes.

1. To the extent that the collateral for the loan, or other amount payable, also includes additional collateral owned by others than customers, the valuation of such collateral shall be shown separately and designated as owned by respondent, general partners, officers, directors, or others, including securities covered by subordination agreements.

2. If collateralized entirely by "exempted securities," the amount of the borrowing, or amount payable to a banking or brokerage house, and the valuation of the collateral shall be stated separately

Question 3—Money Borrowed, and Accounts Carried for Respondent by Other Banking or Brokerage Houses, Unsecured, or Secured Entirely by Collateral Owned by Respondent and Its Partners or Its Officers and Directors, or by Securities Covered by "Satisfactory Subordination Agreements."

State separately totals of ledger net debit balances; ledger net credit balances; long security valuations; short security valuations; spot (cash) commodity valuations, net losses and net gains in future commodity contracts, and classify as follows:

A. Money borrowed:

1 From banks, trust companies, and other financial institutions

2. From officers and directors

3. From others.

B. Accounts carried for respondent by other banking or brokerage houses.

1 Securities accounts:
a. Accounts with net debit balances
b. Accounts with net credit balances.

2. Commodities accounts:
a. Regulated commodities futures accounts:
i. Accounts liquidating to an equity
ii. Accounts liquidating to a deficit.

b. Nonregulated commodities futures accounts:
i. Accounts liquidating to an equity
ii. Accounts liquidating to a deficit.

c Spot (cash) commodity accounts:
i. Accounts with net debit balances
ii. Accounts with net credit balances.

Note: State separately borrowings under A or credit balances under B.1.b and/or B.2 c.ii ·

1. Unsecured
2. Not adequately collateralized under Rule 15c3–1(*c*)(6)
3 Collateralized in whole or in part by securities and/or commodities reportable under 8 or 9 B. Designate valuation of such collateral and state separately amounts adequately collateralized by "exempted securities"

Question 4—Other Open Items With Brokers and Dealers.

State separately totals of ledger debit balances; ledger credit balances; long security valuations; short security valuations, and classify as follows.

A. Securities borrowed (i.e, amount to be received from others upon return to them of securities borrowed by respondent).

B. Securities failed to deliver (i.e., amount to be received from brokers and dealers upon delivery of securities sold by respondent).

C. Securities loaned (i.e., amount to be paid to others upon return of securities loaned by respondent):

1. Customers' securities
2. Securities reportable under 8 or 9.B.
3. Securities reportable under 9.A., 10, 11, and 12.

1 ,ecurities failed to receive (i.e., amount to be paid to brokers and dealers upon receipt of securities purchased by respondent).

1. For customers
2. For accounts reportable under 8 or 9.B.
3. For accounts reportable under 9.A., 10, 11, and 12:

a. Sold at date of report

b. Unsold at date of report.

Notes:

1 Where it is impractical or unduly expensive to allocate all securities loaned and all securities failed to receive to each category in C and D, proper allocation shall be made to the extent feasible and all other such credit balances and short security valuations shall be reported under C 1 and/or D.1, respectively.

2. State separately or in a footnote, ledger debit balances; ledger credit balances; long security valuations; short security valuations, with respect to each security transaction outstanding 30 days or longer under Question 4.B., Securities Failed to Deliver, and Question 4.D., Securities Failed to Receive.

Question 5—Valuations of Securities and Spot (Cash) Commodities in Box, Transfer and Transit.

State separately the total valuation of:

Negotiable securities in box, transfer, and in transit between offices of respondent

B. Spot (cash) commodities represented by warehouse receipts or bills of lading in box and in transit between offices of respondent.

Note · Question 5 requires entries in short valuation column only.

Question 6—Customers' Security Accounts.

State separately totals of ledger debit balances; ledger credit balances; long security valuations; short security valuations, and classify as follows:

A. Bona fide cash accounts (i.e., accounts having both unsettled money balances and positions in securities which are current items within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System):

1. Accounts with debit balances
2. Accounts with credit balances.

B. Secured accounts:

1. Accounts with debit balances
2. Accounts with credit balances.

C. Partly secured accounts (accounts liquidating to a deficit):

1. Accounts with debit balances
2. Accounts with credit balances.

D Unsecured accounts.

E. Accounts with credit balances having open contractual commitments.

F. Accounts with free credit balances.

G. Fully paid securities not segregated.

Notes:

1. Cash accounts which are not "bona fide cash accounts" shall be reported under B, C, or D, as appropriate.

2. Do not combine the accounts of customers except as permitted by General Instruction B.6.

3 Each joint account carried by respondent in which respondent has an interest shall be so stated, separately, as a customer's account in the proper classification and the status of the respondent's interest therein shall be stated. Funds received by respondent as margin in these accounts shall be separately stated by account. If any funds have been provided by the respondent as margin, these shall be clearly indicated here and in the answer to Question 13.

4 With respect to contractual commitments state as a footnote or in a separate schedule the total of:

a Deficits in the accounts of the respective customers reported in the answers to B and/or E after application of net losses in open contractual commitments in securities carried for each such customer.

b. Net losses in open contractual commitments in securities carried for each customer whose account is reported in the answers to C or D.

In computing net losses, gains at market and profits on such sales may be applied against losses only in the same security in each customer's account.

5. See General Instruction B 11 for definition of the term "contractual commitments"

Question 7—Customers' Commodity Accounts.

State separately totals of ledger debit balances; ledger credit balances; spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows.

A. Accounts with open future contracts liquidating to an equity:

1. Regulated commodities
2. Nonregulated commodities.

B. Accounts with open future contracts liquidating to a deficit:

1. Regulated commodities
2. Nonregulated commodities.

C. Accounts with spot (cash) commodity positions:

1. Hedged:
a. Secured
b. Partly secured.
2 Not hedged:
a. Secured
b. Partly secured.

D. Unsecured debit balance.

E. Accounts with free credit balances.

1. Regulated
2. Nonregulated.

Note. See notes 2 and 3 to Question 6.

Question 8—Accounts of Officers and Directors.

State separately, in accordance with the applicable classifications and instructions of Questions 6 and 7, totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations, short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts in the accounts of:

A. Officers.

B. Directors.

Note: If an individual is both an officer and a director, classify the accounts under 8.A

Question 9—General Partners' Individual Accounts.

State separately totals of ledger debit balances: ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Individual accounts of general partners who have signed specific agreements that cash, securities, commodities, and equities recorded in these accounts are to be included as partnership property.

B. All other accounts of general partners. (These accounts shall be classified in accordance with the applicable classifications and instructions of Questions 6 and 7.)

Notes:

1. Total valuations of "exempted securities" reported in answer to Question 9.A. shall be stated separately.

2. The noncapital accounts of partners other than general partners shall be included either with customers' accounts in the appropriate classifications of Questions 6 and 7 or, where applicable, in Question 12.

Question 10—Trading and Investment Accounts of Respondent.

State separately totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

A. Securities accounts:

1. Exempted securities
2. Other securities.

B. Commodities accounts:

1. Future commodities contracts
2. Spot (cash) commodities;
a. Hedged
b. Not hedged.

C. Other.

Notes:

1. Ledger balances may be combined with respect to all security accounts, and also with respect to all spot (cash) commodity accounts

2. Treasury stock of respondent shall not be included hereunder.

3. In the case of a sole proprietor, see General Instruction B 9

Question 11—Capital Accounts.

State separately totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations, short security and spot (cash) commodity valuations, and classify as follows:

A. Sole proprietorship:

1. Capital account
2. Undistributed profit and loss accounts, including balances remaining in income and expense accounts. (This question may be answered by giving one net amount.)

B. Partnership:

1. Capital accounts of general partners
2 Capital accounts of special or limited partners
3. Undistributed profit and loss accounts, including balance remaining in income and expense accounts. (This question may be answered by giving [illegible] net amount.)

C. Corporation or similar entity:

1. Capital stock (detail by class of stock showing number of shares and par value):

a. Authorized (state parenthetically)

b. Issued

c. Treasury stock.

2. Capital surplus

3. Earned surplus or deficit, including balances remaining in income and expense accounts. (This question may be answered by giving one net amount.)

D. Capital reserves. (State nature and amount of each reserve. Valuation reserves and liability reserves shall be reported in answer to Question 13.)

Note: Total valuations of "exempted securities" shall be stated separately.

Question 12—Subordinated Accounts.

State separately for all accounts covered by "satisfactory subordination agreements," totals of ledger debit balances; ledger credit balances; long security and spot (cash) commodity valuations; short security and spot (cash) commodity valuations; net losses and net gains in future commodity contracts, and classify as follows:

' Subordinated accounts:

Accounts with debit balances

2. Accounts with credit balances.

B. Subordinated borrowings.

Notes:

1. Total valuations of "exempted securities" shall be stated separately.

2. Any subordinated account reported under this question must be subject to an agreement which complies with the requirements of Rule 15c3–1(*c*)(7) or, if the respondent is a member of an exchange whose members are exempt from Rule 15c3–1 by subparagraph (*b*)(2) thereof, complies with the rules regarding subordination agreements of all the exchanges therein listed of which respondent is a member. Subordinated accounts with agreements that do not comply with the above requirements must be reported in the answers to Questions 2 through 9, as appropriate.

Question 13—Other Accounts, etc.

State details (ledger balances; valuations of securities and spot (cash) commodities; status of future commodity positions; and any other relevant information) of any accounts which have not been included in one of the answers to the above questions. These shall include: accounts for exchange memberships; furniture, fixtures, and other fixed assets; valuation reserves; funds provided or deposited by the respondent as margin in joint accounts; revenue stamps; divid ds receivable, payable, and unclaimed; floor brok ge receivable and payable; commissions receivable and payable; advances to salesmen and other employees; commodity difference account; goodwill; organization expense; prepaid expenses and deferred charges; liability reserves; mortgage payable; other liabilities and deferred credits; market value of securities borrowed (other than for delivery against customers' sales) to the extent to which no equivalent value is paid or credited; and other accounts not specifically mentioned herein.

Note: Any liability reported under this question secured by collateral in any form shall be identified by reference to the related collateral.

The responses to Questions 14, 15, and 16 shall not be included in the totals.

Question 14—Contractual Commitments That Are Not Recorded in a Ledger Account for Money.

State separately for each type of commitment total cost; total proceeds; valuation of net long and/or short position for the following:

A. Respondent (see notes 2 and 3).

B. General partners who have signed specific agreements that cash, securities, commodities and equities recorded in these accounts are to be included as partnership property.

C. Subordinated accounts.

D. Other general partners, officers and/or directors:

1. Accounts not fully secured (including unsecured accounts)

2. Commitments which are substantial in view of the capital of the respondent.

E. Customers:

1. Accounts not fully secured (including unsecured accounts)

2. Commitments which are substantial in view of the capital of the respondent.

Notes:

1 See General Instruction B.11 for definition of term "contractual commitments."

2. As to underwriting commitments, the amounts reported shall represent the respondent's interest in the entire account.

3. Related good faith deposits shall be clearly indicated; the total thereof shall be included in the amount reported in answer to Question 1.

4. The details required by Part II(a) may be reported herein.

Question 15—Participations of the Respondent in Joint Trading and Investment Accounts Carried by Others That are not Recorded in a Ledger Account for Money.

State separately for each joint account (1) the account balance, exclusive of deposits; (2) the total market valuations of long securities, short securities, and commodities; and (3) the respondent's share of such account balance and each such market valuation. Any related deposits reported in answer to Question 13 shall be clearly indicated hereunder.

Question 16—Unrecorded Assets, Liabilities and Accountabilities.

Submit a separate schedule containing a description of any assets, liabilities and accountabilities of the respondent, actual or contingent, which are not included in a ledger account or reported in answer to Questions 14 and 15. Only such items which in the aggregate are material in relation to net capital need be reported. Accountabilities shall include cash and/or other property including securities held for customers by or on behalf of respondent, which are not included in a ledger account. Contingent liabilities may include lawsuits pending against the respondent, accommodation endorsements, rediscounted notes, and guarantees of accounts of others.

Part II

SUPPLEMENTARY INFORMATION

Submit the following information:

(a) Separate schedules giving adequate description including quantity, price, and valuation of each security and commodity position supporting each total valuation reported in answer to the following:

Questions 6 and 7—Joint accounts in which respondent has an interest.

Questions 6.C., 7.C.1.b., and 7 C 2 b.—Customers' partly secured accounts.

Question 8—Partly secured accounts of officers and directors.

Question 9A.—Individual accounts of general partners who have signed specific agreements that cash, securities, commodities, and equities recorded in these accounts are to be included as partnership property.

Question 9.B.—Partly secured accounts of partners reported in response hereto.

Question 10—Trading and investment accounts of respondent.

Question 11—Capital accounts.

Question 12—Subordinated accounts and borrowings.

The schedule shall show with respect to each borrowing or claim the name of the lender, the relationship to respondent, the amount of the borrowing or claim and the maturity date of the agreement.

Question 14—Contractual commitments that are not recorded in a ledger account for money reported in answer to Questions 14.A., 14.B., 14.C., 14.D.1., and 14.E.1., Part I.

In addition to the details of securities and commodities positions, report the total cost and total proceeds for each security and commodity; the totals thereof shall agree with the amounts reports in answer to Question 14, Part I.

Where contractual commitments exist in puts or calls, or any combination thereof, the details shall include separately with respect to puts or calls in each separate security of the same class: quantity, description of security, expiration date or range of expiration dates, indicated contract costs or proceeds, market valuation and indicated unrealized profit or loss This information shall be reported in separate columns, classified separately and grouped as puts or calls.

Where contractual commitments are related to positions in other securities reflected in the answers to questions in Part I such relationship shall be c y described.

The above information may be reported in Part II(a) or in the answer to Question 14, Part I.

Question 15—Participations of the respondent in joint trading and investment accounts carried by others that are not recorded in a ledger account for money.

Notes:

1 "Exempted securities" and "securities not readily marketable" shall be stated separately.

2 If the respondent is not exempt from the provisions of Rule 15c3-1 but desires that, where allowed, greater than 70 percent of the market valuation of certain securities be included in the computation of net capital under that rule, such securities shall either be listed by groups in accordance with the classifications of Rule 15c3-1(*c*)(2)(C) or the applicable percentages allowable under that rule shall be stated with respect to each security and a summary of valuations by such percentages shall be given.

(b) A schedule showing in detail ledger balances, valuations of long and short securities and spot (cash) commodities, and net losses and net gains in future commodity contracts and other open contractual commitments (other than those reported in the answers to Part I of this Form) in any accounts carried by other brokerage houses in which a sole propriet r any general partner of the respondent has an interest.

(Accounts containing only free securities or free credit balances need not be reported.)

(c) (i) A separate schedule showing the market value of all long and all short future commodity contracts in each account other than customers' commodity accounts reported in answer to all Questions in Part I of this Form (contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions, and accounts of general partners, officers or directors not subject to percentage deduction [Rule 15c3-1(*c*)(2)(D)] shall be so designated).

(ii) A separate schedule showing the market value of all customers' long and all customers' short future contracts in each commodity reported in answer to all Questions in Part I of this Form.

(d) If the answer to Question 11 includes amounts authorized or proposed to be distributed or withdrawn within the next 6 months, furnish the details.

(e) If respondent is a sole proprietor, state whether any liabilities which are not reflected in the answers to Part I of this Form would materially affect net worth as reported; if such liabilities would materially affect net worth as reported, the statement required by Item 7 of the Audit Requirements shall be furnished as a schedule.

(f) If the respondent has met the conditions specified in subparagraph (*a*)(2) of Rule 15c3-1 throughout the year and desires that the lower net capital requirements apply, a specific statement to that effect shall be furnished as a schedule.

AUDIT REQUIREMENTS

The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the pe ' since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date. Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(*b*)(3).

The scope of the audit shall include the following procedures, but nothing herein shall be construed as limiting the audit or permitting the omission of any additional audit procedure which an independent public accountant would deem necessary under the circumstances. As of the audit date the independent public accountant shall:

(1) Compare ledger accounts with the trial balances obtained from the general and private ledgers and prove the aggregates of subsidiary ledgers with th respective controlling accounts.

(2) Account for by physical examination and comparison with the books and records: all securities, including those held in segregation and safekeeping; material amounts of currency and tax stamps; warehouse receipts; and other assets on hand, in vault, in box or otherwise in physical possession. Control shall be maintained over such assets during the course of the physical examination and comparison.

(3) Verify securities in transfer and in transit between offices of respondent.

(4) Balance positions in all securities and spot and future commodities as shown by the books and records at the audit date

(5) Reconcile balances shown by bank statements with cash accounts. After giving ample time for clearance of outstanding checks and transfers of funds, the independent public accountant shall obtain from depositaries bank statements and canceled checks of the accounts and by appropriate audit procedures substantiate the reconciliation as of the audit date.

(6) Obtain written confirmations with respect to the following (see note):

(a) Bank balances and other deposits.

(b) Open contractual positions and deposits of funds with clearing corporations and associations.

(c) Money borrowed and detail of collateral.

(d) Accounts, securities, commodities, and commitments carried for the respondent by others.

(e) Details of:

(i) Securities borrowed

(ii) Securities loaned

(iii) Securities failed to deliver

(iv) Securities failed to receive

(v) Contractual commitments (see General Instruction B.11).

(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared "regular way" purchases and sales of securities) accompanying the first request for confirmation mailed by the independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.

(g) Borrowings and accounts covered by "satisfactory subordination agreements."

(h) Guarantees in cases where required to protect accounts guaranteed as of audit date.

(i) All other accounts which in the opinion of the independent public accountant should be confirmed.

Note: Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary, provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation requests; and it is further provided that with respect to periodic investment plans sponsored by member firms of a national securities exchange, whose members are exempted from Rule 15c3-1 by paragraph (*b*)(2) thereof, the independent public accountant examining the financial statements of the originating member firm may omit direct written confirmation of such plan accounts with customers when, in his judgment, such procedures are not necessary, if (1) the originating member firm does not receive or hold securities belonging to such plan accounts and does not receive or hold funds for such accounts, except the initial payment which is promptly transmitted to the custodian; (2) the custodian is a member firm of such national securities exchange and files certified reports complying with Rule 17a-5 in connection with which the customers' accounts are confirmed by an independent public accountant; and (3) funds and securities held by the custodian for each such customer's account are reconciled with the records of the originating member firm as of the date of the most recent audit of the custodian.

(7) Obtain a written statement from the proprietor, partner (if a partnership) or officer (if a corporation) as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

(8) Verify the computation of the ratio of aggregate indebtedness to net capital at the audit date and review the procedures followed in making the periodic computations required under the provisions of Rule 17a-3(*a*)(11).

NOTE: PROVISIONS OF RULE 17a-5 REQUIRE THAT THE REPORTS OF CERTAIN BROKERS AND DEALERS BE AUDITED BY A CERTIFIED PUBLIC ACCOUNTANT OR PUBLIC ACCOUNTANT WHO SHALL BE IN FACT INDEPENDENT. WITH RESPECT TO QUALIFICATIONS OF ACCOUNTANTS, ACCOUNTANT'S CERTIFICATE, OPINIONS TO BE EXPRESSED, AND EXCEPTIONS, PLEASE REFER TO RULE 17a-5.

APPENDIX C

NEW YORK STOCK EXCHANGE, INC., ELEVEN WALL STREET,
New York, N.Y., July 27, 1971.

MR. IRVING M. POLLACK,
Division of Trading and Markets, Securities and Exchange Commission, Washington, D.C.

DEAR MR. POLLACK: We are in receipt of your June 25th letter regarding the "serious deficiencies in audits" which we mentioned in our letter to Chairman Casey regarding "unsafe and unsound practices of broker/dealers". We felt that in reply it would be helpful to send a listing of some of the types of deficiencies we had in mind and then, if desired, our staff could meet with you and go over the details. The types of problems we referred to are:

1. Item #3 of Rule 417.10 requires that the auditors verify securities in transfer and in transit between the offices of the respondent. On occasions, the auditors have reported substantial amounts in transfer which they have not been able to confirm as valid positions. However, the auditors do not necessarily report the aging of these unconfirmed items nor do they necessarily require reserves on these items. This also applies to inter-office and inter-company accounts which should normally zero out.

2. Misclassification of customers partly secured accounts as bona fide cash accounts.

3. Item #7 of Rule 417.10 requires the auditors to obtain a written statement as to the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent. On occasions, particularly in firms with operations problems, the auditors did not obtain such a written statement.

4. On occasions "control stock", unregistered stock and other securities not readily marketable were valued and no indication given that they were not readily marketable. We are concerned that securities "counts" do not really review the certificate for other than class and denomination, and that auditors accept representations of management as to marketability of capital and proprietary securities even when some of these securities are otherwise legended.

5. Item #5 of Rule 417.10 requires that the auditors reconcile statements on bank accounts with the balances shown by the books of the member organization. We believe that in the case of some inactive bank accounts these reconciliations have not been completed or that the reconciling items shown as of the audit date are not completely resolved.

6. Item #8 of Rule 417.10 requires that the auditors verify the computation of the ratio of aggregate indebtedness to net capital at the audit date. Consideration should be given to requiring the auditors to make the capital computation as at the audit date and to certify that computation.

7. With respect to comments on material inadequacies we have had instances of innocuously worded comments relative to material inadequacies found to exist in the accounting system which did not adequately disclose the condition which existed in the member organization. We have also experienced auditors filing with the Exchange the material inadequacy letter at a date significantly later than the date of the filing of the answer to the financial questionnaire.

8. When an extension of time is requested for answering a financial questionnaire, the auditors are requested to answer four specific questions. The answers which are given by the auditors in many cases are extremely vague and do not adequately respond to the questions.

9. We have also had experiences where the auditors have felt that the firm was failing to meet the net capital requirements and the firm was disputing this fact. In cases, the auditors and the firm both failed to notify the Exchange when it appeared that there was a capital violation.

10. Auditors reconciliations of brokers correspondent omnibus accounts have not been treated as seriously as necessary.

11. There have been some deficiencies in auditors checking of material entries occurring near the audit where investigation would have shown parking and other deception, booking of income without related expense items and the like.

12. We sometimes question the role of auditors in accepting reserves established by management, or the influence of management on auditors in reserves established by auditors.

The above are a few broad examples of some of the deficiencies: In addition, a review of the surprise feature of the audit requirements would be appropriate. More specific examples or specific illustrations of these items could be prepared. We would be pleased to attend, at your convenience, a meeting with the Chief Accountant and other members of the SEC staff. I would anticipate that the members of our staff who would participate in the meeting are Fred J. Stock, Jr., Assistant Vice President in the Department of Member Firms; Frederic W. Grannis, Chief Examiner; and George Beliakow, Assistant Chief Examiner. I have reviewed the vacation schedules of these three men and believe that the best time for a meeting would be during the early or middle part of August.

Sincerely yours,

ROBERT W. HAACK.

APPENDIX D

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: It is generally recognized that the securities industry has been faced with unprecedented problems during the past three years. More than a dozen New York Stock Exchange member firms failed during the last eighteen months alone, and perhaps another seventy merged into or were acquired by other firms, ceased carrying customer accounts, or gradually liquidated themselves. Failures also have occurred among the smaller brokers, who are members of a regional exchange or the NASD. We are, of course, deeply concerned by these events, as we know you are, and we are pleased to present our views on the questions raised in your letter. Both the facts and the issues are highly complex, but at the risk of over-simplifying, we shall try to be brief.

Let me begin with the second question: "*How have the broker-dealer firms which have recently gone into liquidation and bankruptcy gotten into such difficulties?*" While various factors, particularly the quality of management, differed from firm to firm, in most cases the trouble was traceable to the paperwork tie-up of 1967–1968. The industry as a whole had not modernized and automated its procedures and equipment during the 1950's and early 1960's. This was due in part to the fact that trading was forecasted to increase gradually, and in part to the widely prevalent partnership form of doing business with partners withdrawing profits as they were made, rather than reinvesting them as industrial corporations do. When the unexpected surge of trading volume came, brokers were unprepared to handle orders in a timely and accurate manner. Record keeping broke down and firms lost physical control over the stock certificates themselves. In the course of the hearings conducted last year by the Subcommittee on Commerce and Finance of your Committee (House Report Serial No. 91–9 "Securities Market Agencies") the Commission presented a picture of this situation in some detail.

At some firms the operational crisis was so grave as to require liquidation. In most cases, however, back office problems did not prove fatal until they were combined with the unforeseen financial pressures which arose during the 1969–1970 bear market. This decline in market prices and volume, while not as sudden as that of 1962, for example, was the most prolonged and persistent bear market since the nineteen thirties. At the beginning of 1969, both stock prices and volume started a gradual but sustained slide, which often created new difficulties for brokerage firms. A number of them had just expanded their plant—branch offices and transaction processing facilities—and were committed to a high level of overhead expenses. Commission income dropped significantly, as did income from underwriting and other securities activities. At the same time, firms were forced to expend additional sums to resolve errors remaining from the operations crisis, such as old fail-to-receive items, and stock record differences. Moreover, the financial condition of most firms was further adversely affected by the market value decline in firm trading and investment accounts and by the withdrawal of capital contributed by partners and subordinated lenders. Firms also lost working capital by the reduction in customers' free credit balances and by the increased reliance on non-monetary items to bolster their capital (e.g., subordinated demand notes and subordinated accounts).

Next, I would like to deal with your first and third questions together: "*Have the rules of the self-regulatory groups been effective in preventing and correcting the difficulties?*", and "*Why have some broker-dealer firms apparently been permitted to operate after they have gotten into such difficult financial condition?*" Self-regulation should be strongest in the area of financial responsibility, because firms trading with each other are highly interdependent and all have a direct self-interest in ensuring that a troubled firm does not pull the rest of them down with it. The industry generally has also been conscious of the need to prevent the financial difficulties of a broker from causing losses to its customers, thereby undermining the public confidence upon which the markets rest. However well the self-regulatory mechanism might be able to cope with individual firms in difficulty, it did not prove to be designed to handle industry-wide operational and financial problems of the magnitude experienced during the past three years.

Although the ordinary business can continue to operate despite financial problems, until it becomes insolvent or its liabilities exceed its assets, it has long been recognized that the customers of brokerage firms need to be protected by the application of higher fiscal standards. Pursuant to Congressional authority, the Commission in 1944 made effective a net capital ratio rule the purpose of which was to ensure that a broker had enough liquid capital to meet the ordinary needs of his business, and that he would be shut down, if in trouble, at a time when he would still have enough assets to cover the claims of his customers.

At the time the Commission's net capital rule was put into effect, the rules of the exchanges were more stringent that the Commission's (for example, the NYSE's maximum permissible liabilities to capital ratio was then 15:1 rather than 20:1 as under the Commission's rule), and so the Commission exempted members of the specified exchanges from the applicability of the Commission's rule. Exchange members were usually fairly large firms, but the Commission's rule had to be so framed as to permit small firms to enter and remain in business so long as they did not endanger their customers. Since then, the Commission's rule has been tightened in interpretation and application, while those of most of the exchanges it now appears were relaxed, at least in the last several years. This appears to have resulted from a concern on the part of the exchanges with the difficulties which might be encountered in closing a large firm. The result has been to reverse the respective stringencies of the rules as interpreted from that obtaining originally, and today as interpreted and enforced by the Commission, the Commission's rule affords investors the most protection.

This reversal came about gradually, for the most part. Before the recent financial problems came to the fore, there was arguably little practical difference between the Commission's and the Exchange rules. However, in 1969, as the result of the widespread financial difficulties of the member firms, the NYSE relaxed the interpretation and enforcement of its net capital rule in order to avoid placing a number of firms in violation, which might have had the effect of weakening public confidence in such firms and in the Exchange community.

Because of its Special Trust Fund, the Exchange felt able to adopt a "work-out" approach in a number of cases, whereby the firm was allowed to continue in ostensible compliance with the net capital rule while it attempted to bring its problems under control or until it reduced the size of its operations so that liquidation could be made more easily. In a Special Membership Bulletin dated October 1, 1970, copy enclosed, entitled "Report on Self-Regulation", the NYSE explained its policy in these terms:

"For example, in the case of three major member organizations, the Exchange found itself facing situations where normal application of rules could have meant possible loss for many thousands of customers and potential chaos in the industry. These firms, Dempsey-Tegeler & Co., Inc. McDonnell & Co., and Blair

& Co., carried a combined total of some 165,000 customer accounts. Their paperwork and capital problems were critical.

"With each firm, the Exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction of paperwork backlogs. The hope was a scaled-down firm would present a manageable liquidation situation."

Apart from the decision to follow this policy in the enforcement of its capital rule in at least certain instances, the NYSE as well as the other self-regulatory organizations did not have adequate and timely programs to detect and monitor either the operational or the financial problems of their members. Consequently, by the time, the self-regulatory bodies became fully cognizant of the problems, they had spread to such an extent that they could not be brought under control without the adoption of innovative broad based programs. We also believe the self-regulatory organizations frequently accepted the most optimistic progress estimates from their members who because of their overriding self interest to remain in business, failed to objectively assess their own difficulties. There also seems to have been a hope that conditions would immediately improve with a sustained market upturn. Of course, when market conditions did not improve, the problems intensified.

For these and other reasons, the NYSE, the principal self-regulatory organization, did not foresee and plan the steps necessary to cause a number of firms to correct their problems until their condition had deteriorated substantially. In many instances the NYSE allowed and arranged mergers which brought troubled firms together or combined a firm in a critical state with an ostensibly healthy one. In some cases these combinations were successful; in others they exacerbated existing problems. Moreover, there was some lack of contingency planning and a number of failures were only averted through herculean efforts at the last minute. Nevertheless, the members of the New York Stock Exchange did voluntarily expend in excess of $55 million of trust funds to assist in the liquidation of troubled firms, in recognition of their obligation to protect the customers of such firms from losses. The Exchange has further agreed, at the urging of the Congress, to protect customers involved in certain pending member firm liquidations not presently covered by the Special Trust Fund. The Exchange has also obtained authority to assess its members up to $30,000,000 to cover contingent liabilities which may arise from the Goodbody situation and we understand that it proposes to increase the size of the Trust Fund by $20,000,000. Members of other stock exchanges have also contributed to trust funds which are helping to meet customer losses and thus sustain investor confidence.

You further ask: "*What has been the Commission's role in supervising the work of the self-regulatory groups*". For the past three years, we have been attempting to make the legislative patterns of self-regulation work in the securities industry through numerous actions. We believe it will be helpful to describe generally some of these activities.

From our analysis of complaints about broker-dealers made to the Commission in early 1967, we came to the conclusion that the operations problems were more serious than were generally realized by the industry. Accordingly, we wrote to the ten firms which caused the greatest number of customer complaints, asking them what corrective measures they were taking about their apparent operations problems and whether we or the self-regulatory bodies might be of assistance. In general, the firms indicated that their problems were of a "business" and temporary-nature, which they could handle. They not only opposed government intervention but expressed the view it would actually be harmful.

Our concern was also discussed with the self-regulatory bodies, and in August of 1967, the exchanges curtailed trading hours for a short period. In the fall of 1967 we received the first concrete indication that the operational situation was not improving. We were unable to obtain certain records from Pickard & Co., a NYSE member firm, and we notified the Exchange about our difficulty and our concern at the way the firm was being run. Several months later, when the Exchange examined the condition of the firm, our concern was confirmed and the Exchange commenced to liquidate this firm with the aid of trust fund monies.

In January 1968, the Commission wrote to the New York and American Stock Exchanges and the NASD, expressing concern about "accounting, record-keeping and back office problems and their effect on prompt transfer and delivery of securities." We asked them exactly what steps they and their members were taking to deal with the problem, and what measures they were considering. The responses, at least in our view, underestimated the full seriousness of the overall situation and the need for steps in addition to just closing the exchanges early—a step which was taken early in 1968.

After numerous conferences between the Commission and the self-regulatory bodies, we instituted our own inquiry into operational conditions in the industry. We also solicited and obtained the NASD's participation in this activity. The purpose of this program was twofold: first, to obtain the necessary information on the conditions at all major firms and second, to inspect the major firms to evaluate operational problems in a firsthand manner.

In the summer of 1968, we recognized the necessity for a shorter trading week (in addition to shorter hours) when the NYSE had at first sought only to limit over-the-counter trading where fails were larger than in listed trading (but about 80 percent of such trading is conducted by member firms). We also insisted that the self-regulatory agencies require that their members keep their offices staffed during the one day the market was closed each week. That same month, we called a meeting with Presidents of the exchanges and the NASD, at which they were asked to consider the following measures:

Establishment of a specific period of time within which broker-dealers must accomplish deliveries of funds and securities to customers on trades.

Establishment of an appropriate charge to capital for aged fails-to-deliver.

Making better use of existing clearance facilities for OTC transactions.

Adoption of mandatory "buy-in" procedures.

Establishment of requirements covering accounting and bookkeeping systems, and the number of back office personnel to be maintained by firms.

At the time of the meeting the Commission published a release (Securities Exchange Act Release No. 8335, copy enclosed) which expressed the Commission's concern and expressly cautioned all brokers about their responsibilities related to books and records, financial responsibility, and the prompt delivery of securities and settlement of transactions.

Where inquiries showed that adequate corrective action was not being taken, the Commission instituted both injunctive and administrative actions against specific broker-dealers for violation of Commission rules. The Commission also included as a matter of decision in administrative proceedings against firms with back office problems the issue of suspending the firm's registration pending completion of the proceeding. The possibility of suspending a broker-dealer's registration was a strong measure. However, this was made necessary because the Commission believed it appropriate to consider whether a firm's operational problems were so substantial that its doors should be closed promptly. In one particularly egregious case, the firm had lost control of its books and stock record differences reached the enormous totals of $473 million long (securities whose ownership could not be determined) and $220 million short (securities which could not be located). It continued to accept business as usual, and planned a clean-up program (to research and reduce fails and differences) that displayed no sense of urgency. Although the firm was put under certain operational restrictions by the responsible self-regulatory organization, the restrictions were inadequate to deal with its problems. Accordingly, the Commission instituted an administrative proceeding and thereby caused the firm immediately to employ the necessary accounting help to clean up its records promptly, which it did.

In July, 1968 we issued a release as a forceful reminder of the responsibilities of broker-dealers to their customers with respect to delivering securities and money promptly and maintaining accurate and current records of their transactions. This release (Securities Exchange Act Release No. 8363, copy enclosed) still expresses the Commission's policy on this subject:

"The Commission also warns broker-dealers that it is a violation of applicable antifraud provisions for a broker-dealer to accept or execute any order for the purchase or sale of a security or to induce or attempt to induce such purchase or sale, if he does not have the personnel and facilities to enable him to promptly execute and consummate all of his securities transactions."

In addition, after issuing the release, we wrote to the Presidents of the New York and American Stock Exchanges and of the NASD, suggesting consideration of other measures that could be adopted to reduce volume and minimize fails, including prohibiting for an indefinite period of time all promotional activities and advertising designed to induce customers to engage in securities transactions, and the opening of any new offices or the employment of any new salesmen.

At the Commission's urging, the NASD announced that it was continuing a special examination of its members. Mandatory buy-in rules, urged by the Commission, were adopted by the NYSE and Amex. We suggested to the NASD the adoption of a rule barring a broker from trading a security where he had aged fails-to-deliver. This rule was made effective by the NASD. We also proposed and adopted an amendment to our own rules whereby a percentage of aged fails-to-deliver were charged to capital. Similar rules were adopted by the major exchanges at our request.

In view of the situation, we were concerned when suggestions were made for resumption of full 5 day trading, and after consultation with the exchanges, this was postponed and then only allowed with shortened hours. We also continued to meet with the heads of the self-regulatory bodies in an effort to discuss additional measures which would bring operational problems under better control.

During 1969, the industry's financial problems emerged as its operational ones were receding. As was the case during the back office crunch the year before the Commission spent a considerable amount of time working with the self-regulatory bodies in an effort to be kept informed of the steps being taken and to encourage them to take necessary and appropriate regulatory and enforcement measures with respect to their members. One area of continual concern to us was the detection of financial difficulties at a firm in time for them to be controlled and overcome: in the summer of 1969, we asked the New York Stock Exchange for a report on its program for checking on the financial condition of member firms.

Throughout the summer, the situation appeared to deteriorate with the general market decline, and it became apparent to us that the programs of the self-regulatory bodies were not fully adequate to detect or deal with the problems. We again invited the major national and regional exchanges and the NASD to a meeting early in October, at which time we discussed such topics as:

Existing programs for obtaining information about financial and operational conditions on an overall industry as well as specific broker-dealer basis;

The review and evaluation being made of such information and its utilization to project individual and industry-wide conditions;

The sufficiency of the criteria currently used to evaluate the condition of the industry and the adequacy of the flow and interchange of information among all regulatory groups; and

Programs for dealing with situations where serious financial or operational inadequacies are disclosed.

Neither that meeting, nor a following one later in the month, produced agreement as to an appropriate course of action. For example, our proposal for new financial reporting requirements, and the adoption of a financial questionnaire which would be used by the exchanges, was met with opposition. Among the objections raised were the following: the existing self-regulatory reporting programs were adequate; the Commission was already receiving enough data about exchange members; the report would be burdensome to firms.

Because we were convinced of the need for action in this area, we called a meeting for November 1969, at which time we again met with resistance with respect to our proposals for augmented timely industry-wide financial reporting. However, the NASD agreed that it would develop with us an appropriate financial questionnaire and implement a reporting system applicable to all of its members, exchange and non-exchange alike. We also pursued individual programs with each of the major self-regulatory bodies and stepped up our own monitoring of individual firms.

In the course of reviewing the financial problems of specific firms, in the fall of 1969 we discovered that the New York Stock Exchange was interpreting its net capital rule in a way which appeared inconsistent with the liquidity concept underlying the rule. Since the effect of these interpretations was to weaken the protection to customers, early in 1970 we undertook a major inspection of the Exchange's administration of its net capital rule. Both prior and subsequent to the formal inspection we had numerous discussions with the Exchange about the application of its rule, and we succeeded in reversing the Exchange's treatment of such items as insurance claims, restricted stock, reserves for stock differences, and aged dividends receivable. In each case, the effect of our continuing oversight was to strengthen the efficacy of the rule by decreasing or eliminating the capital credit given for such illiquid items.

Because of the Commission's view that the financial condition of certain New York Stock Exchange member firms was critical, in April 1970 the Commission called the Chairman and Vice Chairman of the New York Exchange (together with its top staff personnel) to meet with the Commission and to review in detail the current condition of its members and the need for further measures. Subsequent to this meeting, the Chairman of the Commission met with the Board of Governors at the Exchange to reiterate the Commission's concern.

The Board of Governors established a special committee both to monitor the financial condition of member firms and to determine what steps should be taken. The members of this committee, which included the Chairman and Vice Chairman of the Board, gave their fullest energies to preventing the collapse of several major firms which were in serious financial trouble, most notably Hayden, Stone, Incorporated and Goodbody & Co. They constantly reviewed the firms brought to their attention by the Exchange's monitoring program and they met with the management of such firms to recommend or direct measures to reduce operating losses and the exposure to customers. Without such attention, the situation would have been immeasurably worse.

In July 1970, the Commission again met with Exchange officials to discuss the Exchange's responsibility to customers of failing firms, the adequacy of the Special Trust Fund, and the urgent need for broker-dealer insurance legislation.

In addition, in June 1970, in an effort to obtain more consistency in the preparation of the required annual financial reports and the treatment of items in computing a firm's capital, we brought together at the Commission's offices representatives of the American Institute of Certified Public Accountants, the New York State Society of Certified Public Accountants together with representatives of the examiners offices of the major national securities exchanges. At this meeting we reviewed the theory underlying the net capital concept pointing out that its principal objective was to test a brokerage firm's liquidity. We expressed our concern with respect to recent departures from this concept in connection with the treatment of a number of items including various error accounts and unsecured receivables. We urged all present to make every effort to attain uniformity in this area consistent with the basic objective underlying the capital rule.

Moreover, during the summer and fall of 1970, we made a number of concrete proposals for changes in the Exchange's net capital rule which would restore some of its potency and make it comparable in stringency to the Commission's rule.

To bring our analysis of the Exchange's interpretation and administration of its financial responsibility rules up to date, in October 1970, we again conducted a broad inspection at the Exchange. These two inspections have involved hundreds of man hours of work in combing through and evaluating financial and operational reports, correspondence. minutes of meetings, and other documents, in an effort to pinpoint any weaknesses in the Exchange's rules and procedures. In addition, during the entire period we were briefed on a weekly, and at times a daily, basis by Exchange officials.

Although we have focused our attention primarily on NYSE member firms because of their size and consequent importance to the industry, we have made strenuous efforts to keep ourselves informed on a current basis as to the financial condition of brokerage firms throughout the industry. We have had our staff inspect hundreds of non-exchange member firms, using a financial/operational questionnaire devised to identify quickly the firm's key problems. These inspections were coordinated with those by the NASD, which has also made surveys periodically at our request to ascertain the condition of its member firms. We have also been in touch with all of the major exchanges on a frequent basis to exchange information and discuss specific problems of mutual concern.

When we have identified a major firm as having severe financial problems, we have worked with the New York Stock Exchange and, in many cases, with the firm itself, in an effort to have the problems brought under control pursuant to a deliberate program. Where customers' funds and securities were endangered, we had ready the necessary court pleadings where major firms were involved so that we could go into court promptly if the Exchange did not take adequate action to protect customers' funds and securities. On occasion we pressed the Exchange to commit its Special Trust Fund in various situations, and we went into court to protect the investors in those cases (First Devonshire, Robinson, and Plohn) where the Exchange did not do so. Where the firm was a member of another stock exchange, we have rendered such assistance as was desired. For example, we worked closely with the Pacific Coast Stock Exchange in two different brokerage failures, to get the PCSE itself appointed as the liquidator, with excellent results for the firms' customers.

We should also mention the unusually large volume of complaints which our staff has processed during the past three years. With extremely limited resources we have helped tens of thousands of customers straighten out their accounts, obtain delivery of certificates, recover unpaid dividends and interest, etc. Unfortunately, we were unable to be as helpful as we would have liked to be to complainants who were customers of firms now in liquidation, where the delivery out of credit balances and securities were governed by court rules.

Finally, we have rendered assistance to various Federal and state governmental bodies, and to court or Exchange appointed liquidators, in an effort to resolve problems at troubled firms. As you know, we have also worked closely with Congress this past year in the drafting of the SIPC legislation and in trying to ensure that the members of your Committee were kept informed as to the gravity of the situation confronting the securities industry and its customers. When hearings commenced on the insurance legislation in April 1970, we strongly urged adoption of an insurance program for the protection of customers of securities firms.

Finally, I will turn to your last question: *"Is it time to consider whether the existing system of self-regulation is adequate for the purposes intended?"* Self regulation has come under severe stress in the last three years or so, particularly in the area of financial and operational regulation. In these areas substantial problems and shortcomings have manifested themselves as indicated in the earlier paragraphs of this letter. Some of these may have become more serious in the light of hindsight than they appeared to the self-regulators at the time. While there were deficiencies in addressing itself to the problems in a timely and strict enough manner, it must also be recognized that self-regulation was inhibited in this area by a natural reluctance to force the liquidation of firms, particularly large firms, with the unpalatable alternatives of serious losses to customers or a heavy drain on industry funds. This problem was most acute among New York Stock Exchange member firms because of the high proportion of the business they handle and the sheer magnitude of some of the firms themselves.

Enactment of the SIPC legislation, which we strongly urged, authorizes and calls for a major change in the existing situation. We foresee two principal consequences. In the first place, it will be possible for regulatory and self-regulatory authorities to become more vigorous in the enforcement of financial and operational regulations, because they need not hold their hand out of concern for existing customers of firms, thereby perpetuating situations which create a danger to future customers. The SIPC legislation in of itself will protect existing customers and, significantly, customers of all firms, not just exchange members. This implies that all should be subject to comparable regulation. It is also to be hoped that industry organizations will be impelled to take more effective action since almost all their members will have to pay assessments and the amount of these assessments will depend in considerable measure on their success, or lack of it, in spotting and avoiding problems.

In the second place, the SIPC legislation potentially commits public funds to the protection of customers of securities firms. This clearly introduces a new dimension since regulatory authorities are now confronted with the additional necessity of protecting the taxpayers money. In the consideration of this legislation the Congress made it clear that this will call for considerably more effective direct regulation by the Commission in financial and related areas. Specifically, the Commission is committed to adopting regulations concerning the securities of a customer's fully-paid securities and establishing reserves for a customer's fully-paid balances.

The experience of the past few years and the enactment of the SIPC bill obviously call for stronger regulation and empower and obligate the Commission to play an increasing part in the regulatory scheme. At the same time self-regulation should be asked to contribute whatever it can to the common effort.

Sincerely,

HUGH F. OWENS, *Commissioner.*

Enclosures.

APPENDIX E

(Securities Exchange Act, release No. 8024; Accounting Series release No. 107, Jan. 18, 1967)

NET CAPITAL REQUIREMENTS FOR BROKERS AND DEALERS—INTERPRETATION AND GUIDE

The Securities and Exchange Commission today released the following staff interpretation of, and guide to computations under, its "net capital" Rule 15c3-1 under the Securities Exchange Act of 1934 (the "Act").[1] This material, which was prepared jointly by the Commission's Division of Trading and Markets (the "Division") and Office of Chief Accountant, is intended to assist brokers and dealers in complying with Rule 15c3-1.

This release is divided into two parts. Part I explains the operation of Rule 15c3-1, including the exemptions therefrom, and discusses the application of the rule with respect to questions frequently presented to the Division for interpretation. Part II of this release consists of an example of the computation of "net capital" pursuant to Rule 15c3-1 made by a hypothetical broker-dealer, and includes a detailed trial balance work sheet with explanatory notes. The work sheet is merely illustrative of the application of Rule 15c3-1.

PART I

A. INTRODUCTION

Rule 15c3-1 was adopted to provide safeguards for public investors by setting standards of financial responsibility to be met by brokers and dealers.[2] The basic concept of the rule is liquidity; its object being to require a broker or dealer to have at all times sufficient liquid assets to cover his current indebtedness.[3] The applicability of the rule does not depend on whether or not a broker or dealer is required to be registered with the Commission, since the exemptive provisions of Section 15(a)(1) of the Act provide exemptions *only* from the registration requirements of that section, and not from other applicable provisions of the Act or the rules and regulations.

Rule 15c3-1 is made up of three parts: a statement of the minimum standards of liquidity to be maintained by brokers or dealers:[4] provisions for exemption from the rule for certain brokers or dealers;[5] and definitions of terms for the purpose of determining liquidity under the rule.[6] Each part will be discussed separately.

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[1] All references to Rule 15c3-1 are to the rule as currently amended (see Securities Exchange Act Release No. 7611, dated May 26, 1965). The text of the amended rule, including an explanation of the effective dates of the amended provisions thereof, is set out in the Appendix hereto.

[2] The rule was adopted under section 15(c)(3) which in effect prohibits any broker or dealer from using the mails or interstate facilities to effect, induce or attempt to induce any over-the-counter transaction in a nonexempted security in contravention of rules or regulations prescribed by the Commission as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to financial responsibility of brokers and dealers.

[3] The need for such liquidity has long been recognized as vital to the public interest and for the protection of investors. As early as 1942, the Commission stated, "Customers do not open accounts with a broker relying on suit, judgment and execution to collect their claims—they are opened in the belief that a customer can, on reasonable demand, liquidate his cash or securities position." *Guy D. Marianette,* 11 S.E.C. 967, 970–71.

[4] Paragraph (a) of the rule. (All paragraph references in the footnotes are to Rule 15c3-1.)

[5] Paragraph (b).

[6] Paragraph (c).

B. General Requirements as to Net Capital Ratio and Minimum Net Capital

The rule prohibits a broker or dealer from permitting his "aggregate indebtedness" from exceeding 2,000 percent of his "net capital," as those terms are defined in paragraphs (c) (1) and (c) (2) of the Rule.[7] This has often been referred to as "the twenty-to-one rule."

In addition, every broker or dealer subject to the rule is required to have and maintain a minimum "net capital" of $5,000.[8] However, the rule permits a minimum "net capital" of only $2,500 for a broker or dealer meeting the following conditions: (i) his dealer transactions (as principal for his own account) are limited to the purchase, sale and redemption of redeemable shares of registered investment companies (mutual funds); (ii) his transactions as broker (agent) are limited to the sale and redemption of mutual funds, the solicitation of share accounts for certain insured savings and loan associations, and the sale of securities for the account of a customer to obtain funds for immediate reinvestment in mutual funds; and (iii) he promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.[9] In this connection, the rule provides[10] that a sole proprietor broker or dealer who otherwise qualifies for the reduced minimum "net capital" requirement of $2,500 may also effect occasional transactions in other securities for his own personal account with or through another registered broker-dealer without having to maintain a minimum "net capital" of more than $2,500 (unless, of course, additional "net capital" is needed to comply with the ratio requirement).[11]

C. Exemptions From the Rule

An exemption from the rule is available for a *broker* who is also licensed as an insurance agent, whose securities business is limited to selling variable annuity contracts as agent for the issuer, who promptly transmits[12] all funds and delivers all variable annuity contracts, and who does not otherwise hold funds or securities for, or owe money or securities to, customers; and *only* if the issuer files with the Commission a satisfactory undertaking that it assumes responsibility for all valid claims arising out of the securities activities of the agent.[13] The rule also provides that this exemption will not be lost to a person conducting such limited type of brokerage business *as a sole proprietor* simply because he effects occasional transactions in other securities for his own personal account with or through another registered broker-dealer.

An exemption from the rule is also provided for members in good standing and subject to specific capital requirements of the American, Boston, Midwest, New York, Pacific Coast, Philadelphia-Baltimore-Washington and Pittsburgh Stock Exchanges.[14] The Commission has reviewed the rules, settled practices and applicable regulatory procedures of those securities exchanges and deems them to impose requirements more comprehensive than those of Rule 15c3-1. However, this exemption is not available to a member of any such exchange if he is not subject to the capital requirements of the exchange; and a suspended member of any such exchange would become subject to Rule 15c3-1, and would have to be in compliance therewith, immediately upon such suspension.[15]

The rule further provides that the Commission may, upon written application, exempt from the rule, either unconditionally or on specified terms and conditions,

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[7] Paragraph (a) (1).

[8] Paragraph (a) (2).

[9] A broker or dealer must comply with *both* requirements: he must maintain a minimum "net capital" of at least $5,000 (or $2,500 if applicable), *and* such "net capital" may not be less than 1/20th of the amount of his "aggregate indebtedness." Thus, depending upon the amount of a broker or dealer's "aggregate indebtedness," his required "net capital" could be considerably greater than the specified minimum.

[10] Paragraph (a) (2) (A).

[11] Such a sole proprietor broker or dealer should be aware, however, that all such transactions, whether he considers them to be part of his business or for his personal account, must be reflected in his books and records in accordance with Rule 17a-3; and that securities so held are treated for "net capital" purposes as provided in Rule 15c3-1. (See also the separate discussion, *infra*, with respect to sole-proprietor broker-dealers.)

[12] The term "promptly transmits" is interpreted to mean as soon as reasonably possible, but not later than four business days after receiving the funds.

[13] Paragraph (b) (1).

[14] Paragraph (b) (2).

[15] See *Strand Investment Co.*, Exchange Act release No. 6705 (1961).

a broker or dealer who satisfies the Commission that because of (i) the special nature of his business, (ii) his financial position, and (iii) the safeguards he has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of the rule.[16] This provision is strictly construed; it is not intended to afford an exemption to any particular class or category of brokers or dealers. Only a broker or dealer who has substantial net worth and who, because of the special nature of his business, has safeguards for the protection of customers' funds and securities should apply for this exemption. *A broker or dealer should not apply for this exemption simply because he is having difficulty in raising the necessary capital.* Any application for this exemption should contain detailed information demonstrating that the applicant can meet all the conditions mentioned above, so that the matter may ordinarily be considered on the basis of the information contained in such application.

D. Definitions

1. "AGGREGATE INDEBTEDNESS"

(a) General

As defined in the rule,[17] "aggregate indebtedness" is the *total money liabilities* (except those specifically excluded as indicated below) of a broker or dealer arising in connection with any transaction whatsoever, including, among other things, money borrowed, customers' free credit balances, credit balances in customers' accounts having short positions in securities, and equities in customers' commodities futures accounts.

A broker or dealer which is also engaged in some other business in addition to its business as a broker or dealer must include the money liabilities of such other business in its "aggregate indebtedness." For example, where a broker-dealer also sells life insurance and accepts payments of premiums that are deposited in a special account pending transmission to the insurance company or return to the applicant, the premium represents a liability of the broker-dealer during the time the funds are in its possession, and therefore should be included in "aggregate indebtedness." [18] In fact, where two partners have exactly the same interest in two partnerships, one partnership conducting a securities business and the other conducting another business, the liabilities and assets of both partnerships should be taken into consideration in determining whether the broker or dealer is in compliance with the "net capital" requirements.

However, not all liabilities of a broker or dealer are taken into account in determining his "aggregate indebtedness"; certain items are specifically excluded, as discussed below.[19]

(b) Exclusions from "Aggregate Indebtedness"

(1) Collateralized Indebtedness

The rule specifically exccludes from "aggregate indebtedness" any indebtedness adequately collateralized[20] by securities (including exempted securities[21]) or spot commodities owned by the broker or dealer.[22] In this connection, since

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[16] Paragraph (b)(3).

[17] Paragraph (c)(1).

[18] The question of whether the assets of such other business may be included in "net capital" depends on the nature of such assets. (See discussion of "net capital," *infra.*)

[19] "Aggregate indebtedness" is not a factor in the computation of "net capital"; it is merely one element in computing the "twenty to one" ratio. Therefore, while certain liabilities are specifically excluded from the definition of "aggregate indebtedness," they are not ordinarily excluded from total liabilities for the purposes of computing "net capital" under paragraph (c)(2).

[20] Paragraph (c)(6) provides that indebtedness shall be deemed to be "adequately collaterized," when the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks regularly making comparable loans to brokers or dealers in the community.

[21] However, as to exempted securities, the exclusion applies only to indebtedness arising from loans where exempted securities are given as collateral; not to indebtedness arising out of the failure to receive exempted securities. Securities "failed to receive" are discussed in the text. The term "exempted securities" is defined in paragraph (c)(3) to mean those securities specifically defined as "exempted securities" in Section 3(a)(12) of the Act.

[22] Paragraphs (c)(1)(A), (c)(1)(B) and (c)(1)(E).

time deposit certificates of a *bank* are securities within the meaning of Section 3(a)(10) of the Act, bank loans adequately collateralized by such certificates owned by the broker or dealer may ordinarily be excluded from "aggregate indebtedness." [23]

Fixed liabilities which are adequately secured by real estate or any other asset which is not included in the computation of "net capital" under paragraph (c)(2) of the rule [24] are also excluded from "aggregate indebtedness." [25]

(2) Securities Loaned and Securities Failed To Receive

Amounts payable against securities loaned which securities are owned by the broker or dealer are excluded from "aggregate indebtedness." [26] Also, amounts payable against securities "failed to receive" which were purchased for the account of, *and have not been sold by*, the broker or dealer are excluded from "aggregate indebtedness." [27] Except for these two exclusions, the amounts payable against other securities loaned and securities "failed to receive" are specifically *included* in "aggregate indebtedness."

(3) Contractual Commitments [28]

The rule also excludes from "aggregate indebtedness" liabilities on open contractual commitments.[29] This exclusion is intended generally to apply to liabilities in connection with firm commitment underwriting contracts, because in computing "net capital" any securities position contemplated by a firm commitment underwriting contract would be subject to a deduction from "net worth" based on the market value of the securities.[30] Therefore, it is not considered necessary to require a broker-dealer to maintain additional "net capital" under the "twenty to one rule" to carry that commitment.

In addition, since a traditional "best-efforts" underwriting ordinarily imposes no obligation on a broker-dealer to pay for the securities being offered until certain events occur (e.g., the sale of the security) the broker-dealer does not ordinarily incur a liability to pay for such securities for purposes of computing his "aggregate indebtedness" until such time as he is under a legally binding obligation to pay funds to the issuer (or to the managing underwriter).[31] However, if the broker-dealer receives advances from the issuer (e.g., for expenses) in connection with a best-efforts underwriting, any liability of the broker-dealer to return the unexpended portion of such advances is not excluded from "aggregate indebtedness."

(4) Satisfactorily Subordinated Debt; Amounts Segregated under the Commodity Exchange Act

Other items specifically excluded from "aggregate indebtedness" are: indebtedness subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement" [32] (however, any interest on such satisfactorily subordinated debt, whether in arrears or currently due, should be included in "aggregate indebtedness" unless the debt arising from failure to pay the interest is also subordinated under the subordination agreement); and amounts segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder.[33]

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[23] The treatment of time deposit certificates for purposes of computing "net capital" is discussed in footnote 49, *infra*.

[24] Paragraph (c)(2) excludes from the computation of "net capital" fixed assets and assets which are not readily convertible into cash, including, among other things, real estate, furniture and fixtures, etc. (This is discussed separately in the section dealing with the definition of "net capital.")

[25] Paragraph (c)(1)(G).

[26] Paragraph (c)(1)(C).

[27] Paragraph (c)(1)(D).

[28] This term is defined in paragraph (c)(5). (See also footnote 52, *infra*.)

[29] Paragraph (c)(1)(H).

[30] See discussion under "Haircuts," *infra*.

[31] See *Investment Bankers of America, Inc.*, Exchange Act release Nos. 6886 (August 16, 1962) and 6994 (January 21, 1963). See also discussion under "Other Excludable Items," *infra*, with respect to funds held by a broker-dealer as agent or trustee.

[32] The term "satisfactory subordination agreement," which is defined in paragraph (c)(7) of the rule, is discussed separately, *infra*.

[33] Tit. 17, ch. I, Code of Federal Regulations ("CFR").

(5) *Other Excludable Items*

(i) *Funds held as Agent or Trustee; Escrow Accounts.*—Questions have frequently arisen as to whether funds held either (1) in a separate account by a broker-dealer as agent or trustee, or (2) in an escrow account by a bank, pursuant to Rule 15c2–4 of the Act,[34] are part of "aggregate indebtedness." Where funds are held in a separate bank account by a broker-dealer as agent or trustee, the amount due to the issuer or the purchasing customers is an obligation of the broker-dealer which must be considered as part of his "aggregate indebtedness." If, on the other hand, the funds are promptly transmitted to an escrow *bank* under an agreement which contains the provisions contemplated by Rule 15c2–4 that the funds will be transmitted *directly* to the persons entitled thereto at the appropriate time, and the broker-dealer has no control over such funds, the funds held by the escrow bank are not treated as part of "aggregate indebtedness."

(ii) *Contingent Liabilities.*—Questions also arise occasionally with respect to whether various items of contingent liabilities are to be included in "aggregate indebtedness." Where a judgment has been rendered against a broker or dealer, the amount of the judgment would have to be included in "aggregate indebtedness" even though an appeal from that judgment may be pending.[35] Whether claims which have not been reduced to judgment are to be included in "aggregate indebtedness" would depend on the particular facts. No general rule can be given that would be applicable to all cases. Accordingly, situations involving contingent liabilities should be presented to the Division for consideration on the basis of the facts in the particular case.

2. "NET CAPITAL"

(a) *General*

The "net capital" of a broker or dealer is essentially his adjusted "net worth." As defined in the rule,[36] it is the excess of his *total* assets over his *total* liabilities,[37] adjusted by adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer, or if such broker or dealer is a partnership, by adding the equities (or deducting the deficits) in the accounts of partners.[38]

As pointed out in the introductory material, the principal purpose of the rule is to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current indebtedness, in order to be able at all times to promptly meet the demands of customers. Therefore, the rule provides that certain assets not readily convertible into cash, although saleable by negotiation, are excluded from "net capital" even though such assets are a part of "net worth." Also, certain other assets, although liquid, are valued at less than their market value in order to provide a cushion for market fluctuations. (The required percentage deductions from "net worth" for those assets are referred to as "haircuts." These are discussed separately.)[39]

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[34] Rule 15c2–4 requires, in effect, that where a broker or dealer participates in the distribution of securities on any basis other than a firm-commitment underwriting, any money received for such securities on any basis whereby payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs must be (A) promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, and promptly transmitted or returned to such persons upon the occurrence of the appropriate event or contingency, or (B) promptly transmitted to a bank which has agreed in writing to hold such funds in escrow for the persons having beneficial interests therein and to transmit or return such funds to such persons when the appropriate event or contingency occurs.

[35] Any claim for indemnity that such broker or dealer might have would not be considered to be an asset readily convertible into cash for purposes of computing "net capital."

[36] Paragraph (c)(2).

[37] As noted earlier, liabilities which are excluded from the definition of "aggregate indebtedness" are included in total liabilities for the purpose of computing "net capital."

[38] "Accounts of partners" are defined in paragraph (c)(4) as the accounts of partners who have agreed in writing that the equities in such accounts maintained with such partnership shall be included as partnership property.

[39] Paragraph (c)(2) also contains provisions excluding liabilities in connection with "satisfactory subordination agreements" when computing "net capital," and relating to the treatment of liabilities of sole proprietor-broker-dealers where such liabilities were not incurred in the course of business as a broker or dealer. These will be discussed *infra* in those sections dealing separately with "sole proprietor-broker-dealers" and "satisfactory subordination agreements."

(b) Fixed and Other Assets not Readily Convertible into Cash

In computing "net capital," a broker or dealer must deduct from his "net worth" all fixed assets and all other assets not readily convertible into cash, to the extent that such assets do not constitute bona fide collateral for actual bona fide indebtedness.[40] The rule contains specific examples[41] of some of the assets which for purposes of computing "net capital" are considered as not readily convertible into cash, including: real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and expenses; good will; organization expenses; deficits in customers' accounts, except in bona fide cash accounts within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;[42] all unsecured advances and loans; and customers' unsecured notes and accounts. Thus, unsecured insurance accounts receivable of a broker-dealer also engaged in the insurance business would be deducted from "net worth" in computing "net capital." Similarly, a broker-dealer's earned commissions receivable, being generally unsecured, would also be excluded from "net capital."[43]

Of course, the specific exclusion from "net capital" of *unsecured* loans and advances and of customers' *unsecured* notes and accounts does not mean that *every secured* loan, advance, note or account is included as part of a broker-dealer's "net capital." A secured receivable may be excluded from "net capital" if, because of the nature of the collateral or for some other reason, the broker-dealer cannot demonstrate that the account is readily convertible into cash.[44] For example, advances made by a broker-dealer to his sales representatives against their commissions to be earned upon monthly payments by planholders of contractual plans for the accumulation of shares of a mutual fund are excluded from "net capital" (on the basis that they are not adequately secured), even though the sales representatives signed loan agreements providing (1) that the amounts owed by them are payable on demand, and (2) that the broker-dealer has liens on all commissions due and to become due to such sales representatives until the indebtedness is satisfied. In addition, notes receivable secured by titles on house trailers, by insurance premium finance contracts, and by second mortgages or second deeds of trust are excluded from a broker-dealer's "net capital" unless the broker-dealer is able to furnish convincing evidence to demonstrate that the notes are readily convertible into cash (i.e., that there is a ready market for the securities—notes).[45]

Securities for which there is no independent market,[46] and securities which cannot be publicly offered and sold by the broker or dealer because of contractual arrangements or other restrictions, also fall within the category of assets which are not readily convertible into cash, and are given no value when computing "net capital." In this connection, the Commission held, in *Whitney-Phoenix Co., Inc.*, 39 S.E.C. 245 (1959), that securities which can be publicly offered or sold by the broker or dealer only after registration under the Securities Act of 1933 or pursuant to some exemption under Section 3(b) of that Act should be given no value for "net capital" purposes until such securities have been effectively

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[40] Where additional collateral is used to secure the indebtedness, it would be up to the broker-dealer to prove the extent to which the assets not readily convertible into cash are collateral for the indebtedness.

[41] Paragraph (c)(2)(B).

[42] 12 C.F.R. 220 4(c).

[43] For example, some dealers sell shares of a mutual fund pursuant to a program whereby the customers make their checks payable to a custodian bank which (1) acts as agent for the various parties in effecting the sale of such shares, (2) confirms the transactions to the customers, and (3) periodically forwards to the dealer the commissions due him. Under those circumstances, the commissions due the dealer, but not yet forwarded by the bank, are treated as an unsecured account which should be deducted from the dealer's "net worth." (However, if a dealer can submit an unequivocal written statement from a custodian *bank* that the sums due the dealer are payable on demand, such receivables would not be deducted from "net worth" when computing that dealer's "net capital.")

[44] See footnote 40, *supra*.

[45] If it can be demonstrated that there is such a market for the notes, then instead of the exclusion under clause (B) of paragraph (c)(2) for the amount of the receivable, there would be a "haircut" applied to the market value of the security (the note) in accordance with the provisions of clause (C) of that paragraph. (See discussion of "haircuts," *infra*.)

[46] See *SEC v. C. H. Abraham & Co., Inc.*, 186 F. Supp. 19 (S.D.N.Y. 1960); *Pioneer Enterprises, Inc.*, 36 S.E.C. 199, 207 (1955).

registered or there has been compliance with an appropriate exemption under Section 3(b).[47]

Other examples of assets ordinarily considered to be assets not readily convertible into cash include a "good faith" deposit by a broker-dealer in connection with a bid for exempted or non-exempted securities; a cash deposit in lieu of, or as security for, statutory or other required bonds of a broker-dealer; oil royalties (unless it can be demonstrated that there is a ready market for such oil royalties); a bank account in which a sole-proprietor broker-dealer is a joint tenant; and the cash surrender value of a life insurance policy, unless such cash surrender value and the face amount of such policy are payable (1) to the estate of a sole-proprietor broker-dealer, or (2) to the broker-dealer, if a partnership or corporation.

Questions have been raised as to how to treat deposits in savings and loan associations which are ordinarily considered to be securities in the form of shares in the association. Generally, if such deposits are in a solvent, federally insured savings and loan association and the broker-dealer can furnish assurances to the Division that the particular federally insured association has been paying such deposits on demand, such deposits may be treated for "net capital" purposes as though they were cash in a bank.

(c) *"Haircuts"*

In computing "net capital," the rule requires deductions from "net worth" of certain specified percentages of the market values of marketable securities and future commodity contracts, long and short, in the capital and proprietary accounts of the broker or dealer, and in the "accounts of partners." (These deductions are generally referred to in the industry as "haircuts.") It also requires a deduction with respect to total long or total short futures contracts in each commodity carried for all customers.[48] The purpose of these deductions from "net worth," is to provide a margin of safety against losses incurred by a broker or dealer as a result of market fluctuations in the prices of such securities or future commodity contracts.

(*1*) *"Haircuts" for Marketable Securities*

The amount of the "haircut" required with respect to marketable securities depends on the nature of the particular security, as follows: (1) in the case of a non-convertible debt security having a fixed interest rate and a fixed maturity date, and which is not in default, the "haircut" ranges between 5 and 30 percent, depending on the percentage by which the market value is less than the face value of such security (2) in the case of cumulative, non-convertible, preferred stock not in arrears as to dividends and ranking prior to all other classes of stock of the same issuer the 'haircut" is 20 percent of market value; and (3) in the case of all other marketable securities, the "haircut" is 30 percent of market value.[49]

The above "haircuts" are also applicable to securities loaned to a broker or dealer pursuant to a "satisfactory subordination agreement,"[50] and to other marketable securities owned by a broker or dealer which he has pledged as collateral to secure his indebtedness to another. However, no "haircut" need be taken with respect to securities which belong to a person other than the broker or dealer and which are in his possession as collateral for an indebtedness to

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[47] However, as discussed earlier, where any of the securities discussed above are in fact pledged as *bona fide* collateral to secure a bona fide indebtedness, the amount to be deducted from "net worth" in computing "net capital" is the difference between the book value of such securities and the amount of the indebtedness actually secured thereby. See footnote 41, *supra*. (In such a situation the borrower would ordinarily be expected to tell the lender of restrictions on their sale.)

[48] Clauses (C) and (E) of paragraph (c)(2) in the case of securities, and clauses (D) and (F) in the case of future commodity contracts.

[49] Subclauses (i), (ii) and (iii) of paragraph (c)(2)(C). A negotiable time certificate of deposit issued by a bank is considered to be a debt security, and if there is a ready, independent market for such security, and if it is not in default, it is subject to the "haircut" required by subclause (i). A nonnegotiable time certificate of deposit would ordinarily be treated as an asset not readily convertible into cash, but if the broker-dealer can demonstrate that the bank will pay the certificate on demand before maturity in the particular substantial value, depending on all the surrounding circumstances in the particular case.

[50] See footnote 58, *infra*, and related textual discussion.

such broker or dealer. Also, the rule provides[51] that no "haircut" need by taken with respect to the following: (i) a security which is convertible into or exchangeable for other securities within a period of 30 days, subject to no conditions other than the payment of money, if the other securities into which such security is convertible, or for which it is exchangeable, are short in the accounts of such broker or dealer or in the "accounts of partners"; or (ii) a security which has been called for redemption and which is redeemable within 90 days. However, this latter exemption is not ordinarily available for redeemable investment company shares for two reasons: first, because they are not "called for redemption"; and second, even though they may be redeemable within 90 days, their redemption value is subject to fluctuation with changes in the market value of the portfolio securities held by the investment companies.

The rule applies the above "haircut" provisions to securities positions contemplated by open contractual commitments.[52] In this connection, a firm commitment underwriting is a contractual commitment, and the required "haircut" is applied to the net long position contemplated by the commitment. This "haircut" is applicable even though there is no public market for the security until after the offering begins. (If, however, no market has developed for the security after the offering has begun, and the underwriter has a position in the security, consideration would then have to be given to whether the securities should be given no value as assets not readily convertible into cash.) As the underwriter sells shares to customers, the number of shares which he is obligated to take down decreases, and the "haircut" is reduced *pro tanto*.[53] However, the rule provides that no "haircut" shall apply to "exempted securities" as defined in Section 3(a)(12) of the Act.[54]

(2) *"Haircuts" for Futures Commodity Contracts*

The rule requires that "haircuts" also be taken with respect to future commodity contracts, as follows: a "haircut" of 30 percent with respect to the market value of all long and all short future commodity contracts (other than those contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer, and if a partnership, in the "accounts of partners"; and a "haircut" of 1½ percent with respect to the total long or total short futures contracts in each commodity, whichever is greater, carried for all customers.

3. SUBORDINATED DEBTS; "SATISFACTORY SUBORDINATION AGREEMENT"[55]

It was previously pointed out that indebtedness subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement" is excluded from "aggregate indebtedness,"[56] and from total liabilities in the computation of "net capital."[57] The combined effect of these exclusions is to treat such

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[51] Paragraph (c)(2)(C).

[52] Paragraph (c)(2)(E). The term "contractual commitments" is defined in paragraph (c)(5) to include underwriting, when-issued, when-distributed and delayed delivery contracts; endorsement of puts and calls; commitments in foreign currencies; and spot (cash) commodities contracts; but does not include uncleared regular way purchases and sales of securities and contracts in commodities futures.

[53] In a "rights" offering where the underwriter has a firm commitment to take down the unsubscribed portion of the underlying securities, if the underwriter can demonstrate that less than 50 percent of the underlying securities will remain unsubscribed he may be permitted to deduct only 50 percent of the required "haircut" during the "rights" offering period.

[54] It also provides that the "haircut" with respect to any individual commitment shall be reduced by the unrealized profit (or increased by the unrealized loss) in such commitment; except that the amount of such reduction shall not exceed the amount of the required "haircut," and in no event shall an unrealized profit on any closed transaction operate to increase "net capital." A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

[55] The term "satisfactory subordination agreement" is defined in paragraph (c)(7).

[56] Paragraph (c)(1)(I).

[57] Paragraph (c)(2)(G).

subordinated loans as if they were part of the broker-dealer's capital[58] in computing his "net capital."

In substance, the rule requires that in order to be considered a "satisfactory subordination agreement," a binding and enforceable written agreement must be executed by *both* the broker-dealer and the lender, whereby a specific amount of cash or specific securities are loaned to the broker-dealer for a period of not less than one year (and giving the broker-dealer the right to the use of such cash or securities as though they were in fact his own) under conditions which effectively subordinate any right of the lender to demand or receive repayment to the claims of all present *and* future creditors of the broker-dealer. The agreement must provide that it may not be cancelled by either party, and that the loan may not be repaid or the agreement in any way be terminated, rescinded or modified by mutual consent or otherwise if the effect would be to put the broker-dealer out of compliance with the "net capital" requirements of the rule. The agreement must also provide that no default of any kind shall have the effect of accelerating the maturity of the indebtedness; and that any note or other written instrument evidencing the indebtedness shall bear on its face an appropriate legend stating that it is issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference.

Thus, the rule contemplates that, if the proceeds of a subordinated loan are to be considered as part of the capital of a broker-dealer, cash or securities will be turned over to the broker-dealer for his use as part of his capital and subject to the risks of his business, and subject further only to an obligation of repayment at the end of the term of the loan.[59] Accordingly, the agreement must contemplate that if repayment cannot be made without reducing the broker-dealer's "net capital" below the amount required by the rule, the subordination must continue, even though the indebtedness is not repaid at maturity. However, the loan may be repaid and the subordination agreement terminated *by mutual consent* if, after repayment, the broker-dealer's required "net capital" is not impaired.

The rule also requires that two copies of the subordination agreement, and of any notes or written instruments evidencing the indebtedness, must be filed, within 10 days after the agreement is entered into, with the Regional Office of the Commission for the region in which the broker-dealer maintains his principal place of business, together with a statement of the name and address of the lender, the business relationship of the lender to the broker-dealer, and information as to whether the broker-dealer carried funds or securities for the lender at or about the time the agreement was entered into. (If each copy of the agreement is bound separately and marked "Non-Public", such agreements will be maintained in a non-public file.) A broker-dealer should give notice of any proposed repayment of the loan, or of termination of or any other change in the agreement, to the Regional Office with which the agreement is filed so that the information on file with that Regional Office is always current and accurate.[60]

E. Sole Proprietor-Broker-Dealer

As indicated earlier, there are special considerations under the rule with respect to determining the "net capital" position of a sole-proprietor broker-dealer. For purposes of computing "aggregate indebtedness" and "net capital," a broker or dealer who is a sole proprietor must also take into account his per-

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[58] If the loan consists in whole or in part of securities, such securities would, of course, be subject to the applicable "haircuts" required by paragraph (c)(2)(C) of the rule.

[59] Where funds or securities are loaned under *any* conditions which permit the lender to retain domination or control over, or otherwise inhibit the broker-dealer's unrestricted use of, such funds or securities, the agreement would not be a "satisfactory subordination agreement" within the meaning of the rule.

[60] If a broker-dealer has any question concerning whether he may properly effect any such repayment, or termination or other change in the agreement, he should request interpretive assistance from that Regional Office with which the agreement is filed.

sonal assets and liabilities not related to the business; [61] and where he conducts some other business in addition to the securities business, the assets and liabilitie of such other business must also be taken into account.[62]

A sole proprietor-broker-dealer who is also engaged in some other business activity as a sole proprietor may record the assets and liabilities and transactions of such other business in the same books of account as he uses for his broker-dealer business or in a separate set of books. A consistent test of protection for the customer of such a sole proprietor requires that "aggregate indebtedness" in this situation must includle all of the money liabilities in connection with this business as a broker-dealer and all money liabilities in connection with any other business in which he is engaged as a sole proprietor, less the specific exclusions provided by clauses (A) through (I) of paragraph (C)(1) of the rule. In computing "net capital," his "net worth" must be determined from the combined assets and liabilities of all of his businesses as a sole proprietor; and, in addition to the adjustments to "net worth" required of all brokers or dealers, whether or not sole proprietors, he is required by clause (H) of paragraph (c)(2) to make a further deduction from "net worth" of any excess of his *personal* liabilities over his *personal* assets.

This situation suggests the advisability of the formation of one or more corporations to carry on the securities business or any other business conducted by the sole proprietor. The separate incorporation of the other buisness will tend to relieve the securities business of the jeopardy from the liabilities of the other business and eliminate the question of whether the assets and liabilities of such other business should be taken into account in determining aggregate indebtedness and net capital.

F. Availability of Interpretative Advice

While this release endeavors to answer questions frequently raised, it is not possible to cover every question which may arise under Rule 15c3-1. Moreover, the general opinions expressed herein will not necessarily be applicable to situations which differ factually from those on which such opinions are based. Consequently, a broker or dealer who has a question as to the application of Rule 15c3-1 to a specific matter may request interpretative assistance from the Division of Trading and Markets. While the Commission provides such interpretative assistance through its staff wherever possible, the responsibility for compliance rests with the broker or dealer.

PART II

The following example based on the trial balance of a hypothetical broker-dealer shows the evaluation of the assets and liabilities required to be made in the determination of aggregate indebtedness and net capital. The example includes many situations frequently found in calculations made by small and medium-sized broker-dealers. The trial balance work sheet shows (a) money balances of ledger accounts, (b) long and short security valuations related to certain ledger accounts, (c) net losses or gains in commodity contracts, (d) ledger balances included in aggregate indebtedness, and (e) and (f) adjusted balances of assets and liabilities and percentage deductions. Explanatory notes following the example are referenced to certain of the captions and details of open commodity contracts in both customers' and firm accounts are shown on a separate schedule.

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[61] Note 11, *supra*, with respect to recordkeeping requirements.

[62] These assets and liabilities must be taken into account whether or not reflected in the records of his business as a broker or dealer. For example, where a sole proprietor-broker or dealer also is engaged in the insurance business, any insurance account payable would be included in "aggregate indebtedness," notwithstanding the fact that the sole proprietor maintains a separate bank account and separate books and records for each business. Also, his insurance accounts receivable being ordinarily unsecured, would be excluded from "net capital."

[Amount in dollars]

	Trial balance	Security valuations		Commodity contracts losses (gains)	Aggregate indebtedness	Adjusted balances	
		Long	Short			Assets	Liabilities and deductions
	(a)	(b)	(b)	(c)	(d)	(e)	(f)
ASSETS							
In banks and on hand	25,000					25,000	
Good faith deposit (g)	2,800						
Segregated under Commodity Exchange Act	6,900					6,900	
Deposits on future commodity contracts	1,100					1,100	
Failed to deliver	3,000	3,100				3,000	
Deposit against securities borrowed	10,000	10,200				10,000	
Customers' securities accounts:							
Cash (h)	10,000	11,000				10,000	
Fully secured (h)	81,500	112,000				81,500	
Partly secured (i)	5,000	3,000				3,000	
Unsecured (j)	200						
Customers' commodity accounts:							
Future commodity contracts (k)	(5,700)			(350)			5,700
Spot (cash) commodities (h)	4,500	35,300				4,500	
Accounts of partners (l)	5,000	8,000				8,000	
Firm trading accounts:							
Exempted securities—long (m)	3,000	3,200				3,200	
Non-exempted securities—long (m)	12,000	18,000				18,000	
Non-exempted securities—short (m)	(2,000)		1,600				1,600
Securities not readily marketable (n)	2,000						
Future commodity contracts (o)				(500)		500	
Land and building (p)	48,000						
Furniture and fixtures (p)	6,000						
Exchange memberships (q)	10,000						
Notes receivable, unsecured (q)	1,500						
Advances, unsecured (q)	900						
Dividends receivable (q)	500						
Earned commissions receivable (q)	1,400						
Prepaid expenses (q)	500						
Other assets (q)	1,500						
	234,600						

LIABILITIES AND NET WORTH

Bank loans collateralized by:							
Firm securities (r)	10,000		20,000				10,000
Customers' securities	75,000		105,000		75,000		75,000
Failed to receive:							
Firm securities—long (s)	1,000		1,100				1,000
Customers' securities	5,000		5,200		5,000		5,000
Deposits against securities loaned:							
Firm securities (s)	3,000		3,200				3,000
Customers' securities	2,000		2,100		2,000		2,000
Customers' free credit balances	21,000				21,000		21,000
Accounts payable	7,350				7,350		7,350
Accrued expenses and taxes	6,500				6,500		6,500
Dividends payable	1,400				1,400		1,400
Mortgage payable on land and building (p)	30,000						
Commodity "difference" account (t)	850			850			850
Valuation of securities and spot (cash) commodities in "box" and transfer (u)			77,600				
Contractual commitment (v)							
Total	163,100						
Subordinated borrowings:							
Loan payable (w)	13,000						
Non-exempted securities (w)		4,000				4,000	
Capital:							
Ledger balances	50,000						
Non-exempted securities (x)		8,000				8,000	
Profit and loss	8,500						
Total	234,600	215,800	215,800				
"Haircuts":							
Firm securities (y)							11,880
Firm commodities (z)							7,755
Contractual commitments (aa)							7,500
Customers' commodities (bb)							780
AGGREGATE INDEBTEDNESS					118,250		
Total						186,700	168,315
NET CAPITAL (cc)							18,385
						186,700	186,700

"Net capital" required—greater of $5,000 or 1/20th of "aggregate indebtedness" of $118,250 ... $5,913
"Net capital"—as computed ... $18,385
Ratio of "aggregate indebtedness" to "net capital" ($118,250 ÷ $18,385) (percent) ... 643

The "net capital" of $18,385 is the result of the following adjustments

Capital	$50,000
Profit and loss	8,500
Securities contributed as capital	8,000
Total	66,500
Subordinated borrowings:	
Loan payable	13,000
Securities	4,000
Total	17,000
Total	83,500
Add:	
Unrealized profits:	
Partners' accounts	3,000
Exempted securities—long	200
Non-exempted securities—long	6,000
Non-exempted securities—short	400
Future commodity contracts	500
Total	10,100
Total	93,600
Deduct:	
Land and building	48,000
Mortgage payable	30,000
Total	18,000
Furniture and fixtures	6,000
Cash—good faith deposit	2,800
Deficits in partly secured customers' accounts	2,000
Unsecured customers' accounts	200
Securities not readily marketable	2,000
Exchange memberships	10,000
Notes receivable—unsecured	1,500
Advances—unsecured	900
Dividends receivable	500
Earned commissions receivable	1,400
Prepaid expenses	500
Other assets	1,500
"Haircuts":	
Firm securities	11,880
Firm commodities	7,755
Contractual commitments	7,500
Customers' commodities	780
Total	75,215
"Net Capital"	18,385

EXPLANATIONS TO ABOVE TABLE

(a) The trial balance column includes the ledger balances of all asset, liability and capital accounts. One account, profit and loss, represents the net balance of all income and expense accounts for the period.

(b) The market value of security and spot (cash) commodity positions is entered in these two columns. Generally, long positions indicate ownership or right of possession (customers' securities; firm trading accounts) and short positions indicate location or responsibility to deliver (pledged as collateral on bank loans; sold short; in physical possession—"box"). In order to show a balanced securities position, in this example values have been shown for all accounts in which there is a securities position although not all such values are used in making the evaluations necessary for determination of "aggregate indebtedness" and "net capital." Valuations used in making the "net capital" computation should be supported by schedules showing for each security or spot (cash) commodity: title of issue or other description, market price and total market value.

(c) Balances in this column represent the net unrealized appreciation or depreciation (market value compared to cost) of future commodity contracts and the offset of such amounts to the commodity "difference" accounts.

(d) All liabilities are included as "aggregate indebtedness," except those specifically excluded by paragraph (c) (1.

(e) The asset balances extended to column (e) reflect certain of the adjustments specified in paragraph (c) (2) for determining "net capital."

(f) Column (f) includes all liabilities, except those specifically excluded by provisions of paragraph (c) (2), and the "haircut" on marketable securities, future commodity contracts, and contractual commitments.

(g) A good faith deposit made in connection with an underwriting is considered a balance not readily convertible into cash and is not assigned any value in the "net capital" computation.[63]

(h) Customers' cash accounts, fully secured accounts, and spot (cash) commodities accounts are included in the computation of "net capital" at the amount of their ledger balances. Although such accounts also contain securities or commodities which have a market value greater than the balance due to the broker-dealer, no consideration is given to such excess since these assets belong to the customers.

(i) Partly secured customers' accounts are assigned a value no greater than the market value of the security collateral. In this case, receivables of $5,000 are taken into account at the liquidating value of the related securities, $3,000.[64]

(j) Unsecured customers' accounts are not assigned any value.[65]

(k) The credit balance in customers' future commodity accounts, properly segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder, is excluded from "aggregate indebtedness" but included in liabilities considered in determining "net capital."[66]

(l) Recognition is given to unrealized profits or losses in the accounts of partners who have agreed in writing that the equity in their accounts with the firm shall be included as partnership property. In the example the ledger balances of these accounts is $5,000, but in determining "net capital" the accounts are included at the amount of the market value of the securities, $8,000. If the accounts were not subject to these signed agreements they would be considered as customers' accounts and evaluated only at the amount of the ledger balance, $5,000.[67]

(m) Recognition is given to unrealized profits or losses in the firm securities and investment accounts. In the example the ledger balances of firm trading accounts are stated at book value; consequently, in determining "net capital," security valuations are substituted. The long position in exempted securities is increased from $3,000 to market value of $3,200 and that in non-exempted securities from $12,000 to market value of $18,000. The credit balance in the short position is decreased from $2,000 to $1,600 because the market value of securities necessary to cover the liability is less than the ledger balance.[68]

(n) Securities not readily marketable because no independent public market exists, or which are subject to some restriction as to their sale, are considered as assets not readily convertible into cash and are not assigned any value in determining "net capital."[69]

(o) The unrealized gain of $500 on future commodity contracts in firm trading accounts is taken into consideration in the "net capital" computation since this equity applies to partnership property.[70]

(p) Fixed assets such as land and building, and furniture and fixtures, which in the example are stated net of related reserves for depreciation, are not as-

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[63] Paragraph (c) (2) (B).
[64] *Ibid.*
[65] *Ibid.*
[66] Paragraph (C) (1) (F).
[67] Paragraphs (c) (2) (A) and (c) (4).
[68] Paragraph (c) (2) (A).
[69] Paragraph (c) (2) (B).
[70] Paragraph (c) (2) (A).

signed any value in determining "net capital." The mortgage payable, a fixed liability adequately secured by the land and building, is excluded from both "aggregate indebtedness" and liabilities considered in determining "net capital." [71]

(q) Assets which cannot be readily converted into cash are not assigned any value in determining "net capital." [72]

(r) In debtedness adequately collateralized by securities owned by the firm is excluded from "aggregate indebtedness" but is included in liabilities considered in determining "net capital." [73]

(s) Amounts payable against securities "failed to receive," which were purchased for the account of the firm and have not been sold, are excluded from "aggregate indebtedness" but are included in liabilities considered in determining "net capital." [74] Similarly, amounts payable against securities loaned, which are owned by the firm, are excluded from "aggregate indebtedness" but not from liabilities considered in determining "net capital." [75]

(t) The commodity "difference" account represents the balance of daily settlements with clearing houses on open future commodity contracts which customarily are not allocated to the customers' firm accounts until final settlement of the contract. Of the balance of $850 a portion, $350, represents net gains on contracts in customers' accounts (see (k) above), and the remainder, $500, applies to net gains on contracts in firm accounts (see (o) above). Since sufficient funds have been segregated in a separate bank account or deposited with clearing houses the amount is excluded from "aggregate indebtedness." [76]

(u) The amount of $77,600 in column (b) represents the valuation of securities and spot (cash) commodities in customers' accounts ($49,000) and firm and partners' accounts ($28,600) held in "box" or in transfer.

(v) Liabilities on open contractual commitments are usually not recorded in the ledger accounts and are not included in either "aggregate indebtedness" or in liabilities considered in determining "net capital." [77] In the example a contractual commitment to purchase for $26,750 common stock which has a current market value of $27,500 has not been recorded in the ledger accounts.

(w) A loan payable of $13,000 and non-exempted securities borrowed under "satisfactory subordination agreements" are considered as if they were capital and consequently are excluded from "aggregate indebtedness" and liabilities considered in determining "net capital."

(x) In determining "net capital," securities contributed to capital are considered as assets of the firm.

(y) In the example, as a quick test of compliance, a "haircut" is taken at the maximum rate of 30 percent on the aggregate market value of all non-exempted securities in long and short positions in firm capital and proprietary accounts, including securities in accounts of partners and securities borrowed pursuant to "satisfactory subordination agreements."

The "haircut" is determined in the following manner:

Firm trading accounts:	
Non-exempted securities:	
Long	$18,000
Short	1,600
Partners' accounts	8,000
Subordinated borrowings: Non-exempted securities	4,000
Capital: Non-exempted securities	8,000
Aggregate market value	39,600
30 percent	11,880

Since the use of the maximum rate of 30 percent does not result in a "haircut" which reduces "net capital" below the amount required, no further computation is necessary. If schedules of securities are prepared in accordance with the classi-

[71] Paragraphs (c)(1)(G) and (C)(2)(B).
[72] Paragraphs (c)(2)(B).
[73] Paragraph (c)(1)(A).
[74] Paragraph (c)(1)(D).
[75] Paragraph (c)(1)(C).
[76] Paragraph (c)(1)(F).
[77] Paragraphs (c)(1)(H) and (c)(5).

fications of paragraph (c)(2)(C) then "haircuts" of lesser amounts may be applied as appropriate.[78]

(z) A "haircut" is taken on the aggregate market value of all future commodity contracts in long and short positions in firm accounts. As shown on Schedule A, short positions amount to $19,250 and long positions are $6,600 for an aggregate of $25,850, and consequently the "haircut" at 30 percent equals $7,755.[79]

(aa) A "haircut" of $7,500 is based on the contractual commitment to purchase for $26,750, common stock which has a current market value of $27,500 (see (v) above). The "haircut" represents 30 percent of market value, $8,250, reduced by the unrealized profit of $750.[80]

(bb) the "haircut" of $780 on customers' commodities represents 1½ percent of the market values of the greater of the total long or total short future commodity contracts in each commodity carried in customers' accounts. Analysis of the market values of customers' accounts on Schedule A shows that short contracts in wheat of $14,000 exceed long contracts in that commodity, and that short contracts in corn of $38,000 exceed long contracts in that commodity. Thus the "haircut" of $780 is based on the aggregate of $52,000.[81]

(cc) As developed in the example the application of the adjustments and "haircuts" converts "net worth," including subordinated borrowings, of $83,500 into "net capital" of $18,385; "aggregate indebtedness" is $118,250; and the ratio of "aggregate indebtedness" to "net capital" is 643 percent. Since the ratio does not exceed 2,000 per cent and "net capital" exceeds the required minimum of $5,000, the firm is in compliance with the rule.

SCHEDULE OF OPEN FUTURE AND SPOT (CASH) COMMODITY CONTRACTS

	Delivery month	Cost		Market value		Losses (gains)	Ledger balance	
		Short	Long	Short	Long		Debit	Credit
Customers' accounts:								
Future commodities:								
Wheat:								
2 contracts—short	September	$14,400		$14,000		$(400)		$1,500
1 contract—long	September		$7,100		$7,000	100		850
Corn:								
3 contracts—short	July	18,750		19,800		1,050		750
2 contracts—long	July		12,500		13,200	(700)		500
1 contract—short	September	6,200		6,300		100		250
2 contracts—long	September		12,400		12,600	(200)		550
2 contracts—short	December	12,200		11,900		(300)		1,300
Total		51,550	32,000	52,000	32,800	(350)		5,700
Spot (cash) commodities:								
Wheat: 2 contracts—long			14,200		14,600		2,000	
Corn: 3 contracts—long			18,750		20,700		2,500	
Total			32,950		35,300		4,500	
Firm trading accounts:								
Future commodities:								
Wheat: 1 contract—short	September	7,100		7,000		(100)		
Corn:								
1 contract—long	July		6,250		6,600	(350)		
1 contract—short	September	6,200		6,300		100		
1 contract—short	December	6,100		5,950		(150)		
Total		19,400	6,250	19,250	6,600	(500)		

[78] If, for example, the firm trading account included long positions in nonconvertible debt securities with face and market values of $4,000, and cumulative, nonconvertible preferred stocks with market values of $2,000, the computation could be made in the following manner:

	Market value	Rate (percent)	"Haircut"
Nonconvertible debt securities	$4,000	5	$200
Cumulative, nonconvertible preferred stocks	2,000	20	400
All other securities	33,600	30	10,080
Aggregate market value	39,600		
"Haircut"			10,680

[79] Paragraph (c)(2)(D).
[80] Paragraph (c)(2)(E).
[81] Paragraph (c)(2)(F).

APPENDIX

The following amended text of Rule 15c3-1 under the Securities Exchange Act of 1934 became effective, with two exceptions, on July 1, 1965. The exceptions are that the minimum net capital requirements of paragraph (a)(2) did not become effective until December 1, 1965, and that the amendment of the exemptive provisions of paragraph (b)(1) did not become effective until September 1, 1965.

RULE 15C3-1. NET CAPITAL REQUIREMENTS FOR BROKERS AND DEALERS

(a) Every broker or dealer shall have the net capital necessary to comply with all the following conditions:

(1) his aggregate indebtedness to all other persons shall not exceed 2,000 per centum of his net capital; and

(2) he shall have and maintain net capital of not less than $5,000; except that the minimum net capital to be maintained by a broker or dealer meeting all of the following conditions shall be $2,500:

(A) his dealer transactions (as principal for his own account) are limited to the purchase, sale and redemption of redeemable shares of registered investment companies; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker-dealer;

(B) his transactions as broker (agent) are limited to: (i) the sale and redemption of redeemable securities of registered investment companies; (ii) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and (iii) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(C) he promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(b) *Exemptions*

(1) The provisions of this rule shall not apply to any broker who is also a licensed insurance agent under the laws of any state or the District of Columbia, whose securities business is limited to effecting transactions in variable annuity contracts as general agent for the issuer, who promptly transmits all funds and delivers all variable annuity contracts received in connection therewith, and who does not otherwise hold funds or securities for or owe money or securities to customers, if the issuer files with the Commission an undertaking satisfactory to it that the issuer will assume responsibility for all valid claims arising out of all activities of such agent in effecting transactions in such variable annuity contracts: *Provided, however,* That a broker transacting business as a sole proprietor who meets all other conditions of this subparagraph (b)(1) may also effect occasional transactions in other securities for his own account with or through another registered broker-dealer.

(2) The provisions of this rule shall not apply to any member in good standing and subject to the capital rules of the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, the Philadelphia-Baltimore-Washington Stock Exchange, or the Pittsburgh Stock Exchange, whose rules, settled practices and applicable regulatory procedures are deemed by the Commission to impose requirements more comprehensive than the requirements of this rule: *Provided, however,* That the exemption as to the members of any exchange may be suspended or withdrawn by the Commission at any time, by sending ten (10) days written notice to such exchange, if it appears to the Commission to be necessary or appropriate in the public interest or for the protection of investors so to do.

(3) The Commission may, upon written application, exempt from the provisions of this rule, either unconditionally or on specified terms and conditions, any broker or dealer who satisfies the Commission that, because of the special nature of his business, his financial position, and the safeguards he has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of this rule.

(c) *Definitions*

For the purpose of this rule:

(1) The term "aggregate indebtedness" shall be deemed to mean the total money liabilities of a broker or dealer arising in connection with any transaction

whatsoever, including, among other things: money borrowed; money payable against securities loaned and securities "failed to receive"; the market value of securities borrowed (except for delivery against customers' sales) to the extent to which no equivalent value is paid or credited; customers' free credit balances; credit balances in customers' accounts having short positions in securities; and equities in customers' commodities futures accounts; but excluding:

(A) indebtedness adequately collateralized, as hereinafter defined, by securities or spot commodities owned by the broker or dealer;

(B) indebtedness to other brokers or dealers adequately collateralized, as hereinafter defined, by securities or spot commodities owned by the broker or dealer;

(C) amounts payable against securities loaned which securities are owned by the broker or dealer;

(D) amounts payable against securities failed to receive which securities were purchased for the account of, and have not been sold by, the broker or dealer;

(E) indebtedness adequately collateralized, as hereinafter defined, by exempted securities;

(F) amounts segregated in accordance with the Commodity Exchange Act and the rules and regulations thereunder;

(G) fixed liabilities adequately secured by real estate or any other asset which is not included in the computation of "net capital" under this rule;

(H) liabilities on open contractual commitments: and

(I) indebtedness subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement, as hereinafter defined.

(2) The term "net capital" shall be deemed to mean the net worth of a broker or dealer (that is, the excess of total assets over total liabilities), adjusted by:

(A) adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer and, if such broker or dealer is a partnership, adding equities (or deducting deficits) in accounts of partners, as hereinafter defined;

(B) deducting fixed assets and assets which cannot be readily converted into cash (less any indebtedness secured thereby) including, among other things, real estate: furniture and fixtures: exchange memberships: prepaid rent, insurance and expenses; good will; organization expenses; all unsecured advances and loans; customers' unsecured notes and accounts; and deficits in customers' accounts, except in bona fide cash accounts within the meaning of section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;

(C) deducting the percentages specified below of the market value of all securities, long and short (except exempted securities) in the capital, proprietary and other accounts of the broker or dealer, including securities loaned to the broker or dealer pursuant to a satisfactory subordination agreement, as hereinafter defined, and if such broker or dealer is a partnership, in the accounts of partners, as hereinafter defined:

(i) in the case of nonconvertible debt securities having a fixed interest rate and a fixed maturity date which are not in default, if the market value is not more than 5 percent below the face value, the deduction shall be 5 percent of such market value; if the market value is more than 5 percent but not more than 30 percent below the face value, the deduction shall be a percentage of market value, equal to the percentage by which the market value is below the face value; and if the market value is 30 percent or more below the face value, such deduction shall be 30 percent;

(ii) in the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is not in arrears as to dividends, the deduction shall be 20 percent;

(iii) on all other securities, the deduction shall be 30 percent;

Provided, however, That such deduction need not be made in the case of (1) a security which is convertible into or exchangeable for other securities within a period of 30 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible, or for which it is exchangeable, are short in the accounts of such broker or dealer or partner, or (2) a security which has been called for redemption and which is redeemable within 90 days;

(D) deducting 30 percent of the market value of all "long" and all "short" future commodity contracts (other than those contracts representing spreads or straddles in the same commodity and those contracts offsetting or hedging any "spot" commodity positions) carried in the capital, proprietary or other accounts of the broker or dealer and, if such broker or dealer is a partnership, in the accounts of partners as hereinafter defined;

(E) deducting, in the case of a broker or dealer who has open contractual commitments, the respective percentages specified in subparagraph (C) above of the value (which shall be the market value whenever there is a market) of each net long and each net short position contemplated by any existing contractual commitment in the capital, proprietary and other accounts of the broker or dealer and, if such broker or dealer is a partnership, in accounts of partners, as hereinafter defined: *Provided, however*, That this deduction shall not apply to exempted securities, and that the deduction with respect to any individual commitment shall be reduced by the unrealized profit, in an amount not greater than the percentage deduction provided for in subparagraph (C), (or increased by the unrealized loss) in such commitment; and that in no event shall an unrealized profit on any closed transactions operate to increase net capital;

(F) deducting an amount equal to 1½ percent of the market values of the total long or total short futures contracts in each commodity, whichever is greater, carried for all customers;

(G) excluding liabilities of the broker or dealer which are subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement, as hereinafter defined; and

(H) deducting, in the case of a broker or dealer who is a sole proprietor, the excess of (1) liabilities which have not been incurred in the course of business as a broker or dealer over (2) assets not used in the business.

(3) The term "exempted securities" shall mean those securities specifically defined as exempted securities in section 3(a) of the Act;

(4) the term "accounts of partners," where the broker or dealer is a partnership, shall mean accounts of partners who have agreed in writing that the equity in such accounts maintained with such partnership shall be included as partnership property;

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

(6) indebtedness shall be deemed to be "adequately collateralized" within the meaning of this rule, when the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks regularly making comparable loans to brokers or dealers in the community;

(7) the term "satisfactory subordination agreement" shall mean a written agreement duly executed by the broker or dealer and the lender, which agreement is binding and enforceable in accordance with its terms upon the lender, his creditors, heirs, executors, administrators, and assigns, and which agreement satisfies all of the following conditions:

(A) it effectively subordinates any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future creditors of the broker or dealer;

(B) the cash or securities are loaned for a term of not less than 1 year;

(C) it provides that the agreement shall not be subject to cancellation by either party, and that the loan shall not be repaid and the agreement shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of this rule or to reduce the net capital of the broker or dealer below the amount required by this rule;

(D) it provides that no default in the payment of interest or in the performance of any covenant or condition by the broker or dealer shall have the effect of accelerating the maturity of the indebtedness;

(E) it provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference;

(F) it provides that any securities or other property loaned to the broker or dealer pursuant to its provisions may be used and dealt with by the broker or dealer as part of his capital and shall be subject to the risks of the business; and

(G) two copies of such agreement, and of any notes or written instruments evidencing the indebtedness, are filed, within 10 days after such agreement is entered into, with the Regional Office of the Commission for the region in which the broker or dealer maintains his principal place of business, together with a statement of the full name and address of the lender, the business relationship of the lender to the broker or dealer, and whether the broker or dealer carried funds or securities for the lender at or about the time the agreement was entered into. If each copy of such agreement is bound separately and clearly marked "Non-Public" such agreements shall be maintained in a non-public file: *Provided, however,* That they shall be available, for official use, to any official or employee of the United States or any state; to any national securities exchange and any registered national securities association of which the broker or dealer filing such agreements is a member; and to any other person to whom the Commission authorizes disclosure in the public interest;

(8) the term "customer" shall mean every person except the broker or dealer:

Provided, however, That partners who maintain "accounts of partners" as herein defined shall not be deemed to be customers insofar as such accounts are concerned.

APPENDIX F—RE: EASE OF ENTRY

Name	Date of Registration	Time of injunction action	Business	Background of principals previous to registration
John Edwards & Co., Inc.	Jan. 17, 1968	Mar. 17, 1971	3 yrs., 2 mos.	Robert E. Morgan (Exec. V. P.-Treas.): 1½ yrs. Financial Controller, Machine Tool Mfr. Resigned from firm July 14, 1970. Paul G. Jackson (V. P. and Branch Manager), 5 yrs. Personnel in Hospital, previously teller in bank and owner of restaurant. No Sched. D's for Pres. and a Dir., request Nov. 19, 1970.
Andrew T. Love Assoc. Inc.	Mar. 5, 1968	May 12, 1971	3 yrs., 2 mos.	David Allen Barak (Pres.), 2½ yrs. Branch Mgr. B/D, previously admin. position in Mutual Fund B/D (3½ yrs.) and land salesman (1½ yrs.) Eileen Barak (Sec-Treas) 10 yr. secretary. Leo Kieve (V. P.), 2 yr. Reg Rep., previously manager with drug and chem. cos. (20 yrs.)
Stan Ingram & Assoc.	Dec. 22, 1968	Feb. 22, 1971	2 yrs. 4 mos.	Sanford Ingram (Gen. Part.) 3 yrs. Reg. Rep., previously ins. agency Mgr. (3 mos.) and elec. engineer (2 yrs.) Marianne Ingram (Gen. Part.), 2 mos. sales, 6 mos. steno.
International Funding Sec. Inc.	Mar. 30, 1962	June 3, 1971	9 yrs.	No Sched. D's.
M. J. Manchester	Dec. 27, 1968	Apr. 2, 1971	2 yrs., 3 mos.	George C. Bergleitner, Jr. (Pres.), 10 yrs. Reg. Rep. (2 yrs. Partner in firm or Pres. of own firm.) Ira J. Sands (Sec.) 2 yrs. Reg. Rep., prev. 2 yrs. principal of B/D (9 yrs.) Also investor in many real estate ventures 7-8 yrs. Philip S. Polh (Dir.) Bus. broker, importing.
Josephson Co.	Dec. 8, 1968	Mar. 5, 1971	3 yrs., 2 mos.	Joseph A. Garofalo (sole prop.) 2 yrs. reg. rep., previously advertising sales and advertising account exec. (8 yrs).
Orin R. Dudley Co.	Dec. 12, 1963	Feb. 18, 1971	7 yrs., 2 mos.	Orin R. Dudley (sole prop.) 4½ yrs. reg. rep.
Fox-Raff & Co.	Jan. 10, 1968	Mar. 11, 1971	3 yrs., 2 mos.	Richard M. Baldwin (Pres.) 6½ yrs. reg. rep., prev. advertising mgr. for auto dealership (3 yrs.). Alan R. Doe (V P.), 3 yrs. reg. rep., previously salesman (3 yrs.) Elmer R. Haller (V.P.) 7½ yrs. trader with B/D's, previously salesman (1½ yrs.) Charles J. Holderman (V.P.), 11 yrs. reg. rep. Ray E. Lewis (V.P.) 2½ yrs. reg. rep., prev. summer jobs while in school. Carlton E. Olson (V.P.), 5 yrs. reg. rep., prev. bank trainee (1 yr.) Hugh W. Pinnock (stockholder), insurance business, not active in B/D. Gary R. Ritner (V.P.), 5½ yrs. reg. rep., prev. bank trainee (7 mos.) James F. Longergan (?), 3 mos. real estate, prev. reg. rep. (4 yrs.) and accountant (7 yrs.)
McGhee & Co., Inc., Cleveland, Ohio.	Mar. 3, 1954	Mar. 17, 1971[1]	17 yrs.	Normal L. McGhee, Pres., attorney and city councilman (no specific information on Sch. D).

[1] Revoked.

APPENDIX F—RE: EASE OF ENTRY—Continued

Karle Raymond Berglund, d/b/a Colonial Investment Securities, Worcester, Mass.	Dec. 13, 1968	Jan. 15, 1971[2]	2 yrs., 1 mos.	Karle Raymond Berglund (sole proprietor) president of automobile finance company and parttime reg. rep., prior to that, controller for several retail cos.
Zimm Unified Securities, Inc., New York, N.Y.	Oct. 6, 1967	Mar. 19, 1971	3 yrs., 5 mos.	Aron Zimmerman (Pres.) reg. rep. 3 yrs.; during and prior to that, rabbi and dean of a Hebrew college. Renee Zimmerman (V.P.) reg. princ; prior to that housewife. Max Perlstein (Sec./Treas.) accountant with accounting firm, prior to that, student.
Lang-Lasser & Co., Inc., Beverly Hills, Calif. (parent CDL Financial Inc.).	Jan. 3, 1970	June 3, 1971	1 yr., 5 mos.	Clifford Herbert Lang (Pres.) district manager for broker-dealer for 2 yrs., 7 mos.; prior to that, engineer. Leo Cohen (V.P.) reg. rep. for 1 yr., 7 mos.; prior to that, engineer. Alan Paul Wollman (Dir-V.P.) training director for broker-dealer 1 yr., 4 mos.; prior to that, aerospace project director. Roberta Lee Hall (Sec.) sec. to insurance and securities firm; prior to that, administrator with a broker-dealer and insurance company. Peter Roy Lasser (Asst. V.P.) reg. rep. 2 yrs., 6 mos., prior to that student.
Security Planners Ltd., Inc., Boston, Mass., (subsidiary of Security Planners Associates, Inc.).	Feb. 12, 1969	Mar. 18, 1971	2 yrs., 1 mo.	Dexter Lee Fraunce (Pres) pres. of b/d 7½ yrs., prior to that student. Jacques Kunitz (Dir.) vp and sales mgr. for b/d; prior to that, pharmacist and life ins. agent. Howard Simolar (Treas.) exec. v.p. of b/d for 5 yrs.; prior to that, reg. rep. and drug salesman.
C. H. Wagner & Co., Inc., Wellesley, Mass.	June 23, 1969	Mar. 31, 1971	1 yr., 9 mos.	Clarence Hubert Wagner (Pres.) exec. v p. of b/d; prior to that, officer or reg. rep. for various b/d's. Ann Louise Wagner (Sec) reg. rep. and housewife. Neil B. Doherty III (v.p. and treas.) prin. in b/d 9 mos. and retail store for 7 yrs.
Shelby Securities, Inc., Westbury, N.Y.	July 18, 1970	Mar. 11, 1971	8 mos.	Aljan S. Fishman, (Pres.,) reg. rep. for 4 mos.; prior to that, salesman of ins. and soft drinks. Harry Axelrod (Sec./Treas.) cashier in b/d for 3 mos.; prior to that, manager for distributor. Robert W. Herko (V.P.) accountant for securities firm for 6 mos.; prior to that, accountant for nonsecurities firms.
P.L.M. Securities, Inc., Syracuse, N.Y.	Aug. 9, 1967	Apr. 7, 1971	3 yrs., 8 mos.	Peter L. M. Lee (Pres.) reg. rep. dealing in mutual funds, 3 yrs. exper.
Packer, Wilbur & Co., Inc., New York, N.Y.	June 22, 1961	Mar. 25, 1971	9 yrs., 9 mos.	(No Sch. D on file). Wilbur Hyman (Pres.) reg. rep. for 1 yr., 7 mos.; no connection with b/d prior to that. Maurice Rind (V.P.) Robert Berkson (Sec.) no relation to b/d prior to assoc. w/ Packer Wilbur & Co. Archie Packer, dir., v p for b/d for 1 yr., 2 mos.
Samuel H. Sloan & Co., New York, N.Y.	May 10, 1970	June 10, 1971[3]	1 yr., 1 mo.	Samuel Howard Sloan (Gen. Part.) reg rep. for 1 yr. 9 mos.; prior to that a college student and roulette trainee. Harry George Theodos (Partner) engineer for aircraft firm; prior to that, college student.
Howard Carlton, Inc., New York, N.Y.	May 31, 1969	Feb. 1, 1971	1 yr., 7 mos.	Howard L. Lozell (Pres.) salesman and prin. in sales org.; prior to that, salesman.
Philip S. Budin & Co., Inc., Jersey City, N.J.	Oct. 6, 1967	May 5, 1971	3 yrs., 7 mos.	Philip S. Budin (Pres.) trader with 2 b/d's for 7 yrs.; prior to that, a student. Marc Shafran (Sec./Treas.) clerk w/ several b/d's; prior to that, a student. Phyllis Freshman (Dir.) no prior exper. Melvyn Gilbert Block (trader) trader and clerk with several b/d's; prior to that, a student Louis Freshman (Reg. Rep.) reg. rep. with several other b/d's for 5 yrs. prior to that, real estate salesman.

[1] Revoked.
[2] Auth. for injunction.
[3] Authorization.

APPENDIX G

A Brief Description of the Segments of a Broker's Back Office Involved in the Settlement, Clearing, and Transfer Process

INTRODUCTION

As an introduction to the various phases of the back office, a brief description of the clearing and settlement process might be helpful.

The consummation of a securities transaction can occur in basically two ways. First, the selling broker may physically deliver the securities to the buying broker, either directly by messenger or by drafting through the banking system, and await the payment by the buying broker of the purchase price. The second is through the use of a clearing corporation. Clearing corporations can function either as mere clearing houses or involve themselves directly or indirectly in varying degrees in the actual trade completion process. The clearing corporations of the very small national securities exchanges; the Cincinnati Stock Exchange, perform mainly a clearing house function. They are distributing points for the delivery of funds and securities. Selling brokers deliver the securities, with draft attached, to the clearing house which notifies or delivers the securities to the buying broker with a memorandum statement of the money obligation. The buying broker pays the clearing house and the clearing house pays the selling broker. Another type of clearing corporation may become directly involved in the consummation or "settlement" process in several different stages. It may assist in the comparison process—the process by which the buying and selling brokers reach agreement as to the existence of a trade and the terms thereof. It may then continue its role by netting the purchases and sales in each of the cleared securities and allocating the delivery and receipt of the netted balances.

The daily balance order system is typified by the Stock Clearing Corporation (SCC), a wholly owned subsidiary of the NYSE, which has the longest continuous operating history of a clearing corporation and is probably the largest in operation. SCC in the clearance function aids in the comparison process, nets the buys and sells in the compared trades and then allocates the delivery and receipt obligations so that one broker must deliver to or receive from only one broker his net balance in any security. This, however, overlooks the differences in prices at which the various trades were effected, and further requires the establishment of a uniform price at which the payment and receipt obligations for a day's net balances will be settled. This requires the involvement of SCC in the money movement part of the settlement process to adjust the differences in monies between the contract prices and settlement prices. SCC is further involved in the money movement part of the settlement process. Securities deliveries are made in the morning and SCC acts only as a type of mail sorter in this process. Money movements occur in the afternoon. SCC is involved in the money movement to guarantee to the delivering broker, who no longer has custody or control over his securities, that he will be credited for his deliveries.

A clearing corporation may also assume the full role in the settlement process. Settlement occurs when the selling broker delivers the securities and the buying broker pays for them. There are two parts to the settlement process. One is the movement of securities, and the other is cross movement of funds. Having netted and allocated the delivery and receipt obligations of funds and securities, it may then assume the selling broker's obligation on the settlement by delivering securities to the broker who is the net buyer and assume the buying broker's role by delivering money to the selling broker. Thus, the obligation of broker to broker becomes the obligation of broker to clearing corporation, and, in turn, from clearing corporation to broker. This is the net by net clearing system.

BROKER'S BACK OFFICE

There are three components to the securities transaction completion process. The first is the movement of funds from buyer to seller. The second is the movement of securities from seller to buyer. The third is the set of records that the individual participants in this process must maintain. Broker-dealers must maintain two sets of records. The first is the standard set of books maintained by most businesses recording their monies and other assets, liabilities, capital and income. The second relates to the securities aspect of the business—the location, possession or person in control of the securities (short), and the right to, or beneficial or legal ownership of the securities (long). Not only must the broker-dealer maintain two sets of books, he must at various points in the trade completion process bring various accounts in these sets of books together and verify the entries thereto and balances therein. To illustrate these points, set forth below is a description of the back office process followed in consummating a simple agency trade.

From the moment a security transaction is executed until settlement day, the basic processing work within the broker-dealer establishment is the responsibility of the Purchase and Sales Department (P & S Department). This Department establishes the existence of the trade, the parties thereto, and the terms, and reduces the orally executed order to writing. The P & S Department receives a report from the order execution point, whether it be the floor of a national stock exchange or the over-the-counter trader for the firm. This report briefly reflects the security involved, the quantity, the price and the name of the broker on the other side. In over-the-counter transactions this will be the name of the other broker-dealer. For securities cleared through a clearing corporation, this will be the name of the other broker, and the name and number of the clearing broker, if any (the broker-dealer who will assume responsibility for the firm in the clearance and settlement of the transaction). This report is then matched against the open trade orders the P & S Department has received from the firm's registered representatives to ascertain for which customer and which order for that customer was executed. The P & S Department complies the data as to each customer including the account number of the customer, the security, the quantity, the extension (price x unit) sales charges, commission charges, service charges, interest charges and taxes that may be applicable and transmits this data to the Margin Department. It then prepares the necessary documentation to confirm the transaction with the broker on the other side. If the transaction is a non-clearing corporation over-the-counter trade, the P & S Department will prepare a confirmation stating its understanding of the transaction and the terms thereof and send it directly to the broker on the other side of the trade.

If the transaction is to be cleared through a clearing corporation, the P & S Department prepares a "contract list" for that day which reflects all transactions for that day to clear through the clearing corporation, and includes for each trade the clearing number of the other side. the name or number of the broker with whom the transaction was effected if it was not a clearing broker, the symbol of the security involved, the quantity, and the price at which the trade was executed or the total contract value. This contract list will be delivered to the clearing corporation by the end of the trade date or the morning of T plus one (the day after the trade date). At T plus one the P & S Department receives the other side's over-the-counter confirmations and the clearing corporation's contract lists showing (1) those transactions which have been compared, i.e., in which the other side of the trade has reported the same terms and conditions and parties to the trades as the department's firm, and (2) those transactions which the department's firm has not reported but which were reported by another broker as having been executed with him ("advisories" and "non-compares," i.e., those transactions which a broker reports to the other side but which the other broker does not similarly report). The P & S Department will receive the confirmations and the contract lists of other brokers and compare them with the contracts, lists, and confirmations it submitted and prepared. As to those items which do not agree (advisories or non-compares) the P & S Department will attempt to ascertain whether the disagreement was the result of an error on its part. If so, it will make a correction, and in over-the-counter transactions, the P & S Department will submit a new confirmation to the other broker, revised to reflect the corrections. If a clearing corporation is involved the P & S Department will submit a form to the clearing corporation reflecting the revision and indicating by the form that the contract reflected in the form is to be added to or deleted from the list of compared contracts. If the disagreement cannot be resolved by the P & S Department. the P & S clerk may call the P & S Department of the other side and try to resolve the errors or disagreements over the phone. If neither P & S Department can reach agreement. they may refer the matter to their individual traders. Over-the-counter transactions will be referred by the P&S Department to the firm's over-the-counter trader who will be asked to check his records to ascertain the terms and the parties to the transaction in question. On trades on an exchange, if the P & S Departments of the two brokers cannot reach agreement, the matter will be referred to the floor trader for the firm or to the floor trader who had been retained to execute the transaction in question, to compare with his records; and, if he cannot resolve the error, to compare with the records of the floor trader who was on the other side of the transaction. Only those transactions which have been compared can go forward in the clearance and settlement process. If the contract cannot be resolved within the normal five business days it will fall outside the normal process, thereby demanding additional time and effort to resolve the matter. To the extent that the records of a broker-dealer may reflect a transaction and the movement of money and securities as part thereof when in fact the transaction has not been compared and ought not be a valid and enforecable contract, this may create a "difference," "suspense account," or "error account" in the records of the various broker-dealers. If a contract has been compared, the terms thereof are transmitted by the P & S Department to the cashier's department which has control over the payment and receipt of money and the receipt and delivery of securities.

The Margin Department maintains control over the customers' accounts. This department keeps the records regarding the customers' accounts and securities positions and has the responsibility of keeping the firm in compliance with the margin regulations. The Margin Department receives a report from the P & S Department of all transactions effected by customers and causes the results of reports to be posted to the customer account ledgers. The Margin Department also receives reports from the cashier's department of all payments of money by customers and all delivery of securities to the firm by customers. This department not only maintains customers' accounts but also keeps track of customers' funds and securities.

The margin clerk reviews each customer's account after receiving a report of a trade or money or security movement in that account. If the account is a margin account he will determine if additional money or collateral is required and issue the appropriate notice. The confirmation generated by the P & S Department usually contains the bill for cash customers. On settlement date, if the margin clerk is not advised by the cashier that the customer has paid for the securities or posted the required collateral, he is responsible for initiating the necessary steps to either obtain the money or collateral, seek an extension of the time, or issue instructions to liquidate the transaction. The margin clerk maintains the record of the location and use of customer securities of which the firm has taken possession. This includes the pledging of customer securities and compliance with the applicable hypothecation and segregation rules. He must see to it that customers' fully paid and excess margin securities are ordered into "segregation." Similarly, when securities are received as collateral or in settlement of a sale by a customer or purchase by the firm, the margin clerk is advised of this by the cashier and issues the instructions routing the security to the proper location—segregation, free box, pledge, and the like. The margin clerk must also ascertain the buying power of the margin account. This is done to assure compliance with the applicable margin maintenance rules and the firm's own policy. It also helps the registered representatives to know how much equity in customers' accounts may be used as collateral for the purchase of additional securities or for short sales. To accomplish this, the margin clerk periodically computes the customer's indebtedness and the market value of the collateral securities and then determines the necessary collateral to comply with the applicable margin maintenance requirements. The Margin Department also maintains control over the delivery to customers of funds or securities. These requests, which are usually received by the registered representative, while ultimately destined for the cashier, are routed through the Margin Department.

The Cashier's Department is the central location in the brokerage house for the receipt and disbursement of cash and the receipt and delivery of securities. Because it plays such a central role in the operations of the broker-dealer, it generates many of the initial instructions for the subsidiary ledgers from which various control and general ledgers of a brokerage house are constructed. This is the point where the two sets of records maintained by a broker-dealer have the most interaction. The instructions to move securities or funds frequently originate outside of this department. On the day before or the evening of two days before the settlement day, the P & S Department will deliver to the Cashier's department copies of the compared confirmations of the over-the-counter transactions and the balance orders which the broker-dealer must deliver or receive on settlement day. These instructions will be delivered to the cage section—that part of the Cashier's Department which handles the actual movement of securities. It is called the cage because in many firms this is the physical location for the stock certificates, and, because of the value of the negotiable stock certificate, it is under very strict security. The P & S Department will also advise the Stock Record Department of the transactions in securities that have compared so that the appropriate control records for the location of securities due to or due from the firm or its customers may be recorded in the stock record.

The stock record is the central control record of the broker-dealer for the movement of securities. The cage will also receive instructions from the margin clerk to either place securities in, or move them from, segregation. Many firms maintain a book type of segregation. The cage clerk in determining the availability of stock certificates in any specific issue must be aware of the total number of certificates present in that issue and the amount of those certificates which must be "segregated." The balance of the certificates although not physically separate from those which are segregated are "free" for use by the firm to meet contractual obligations, to pledge or to loan. The cage will also receive instructions from the margin clerk as to the withdrawal of securities to be delivered to the firm's customers. The P & S Department will also advise the "receive" section as to those purchase transactions which are to be settled, so that it will accept receipt of the proper kind and number of securities and pay the contract price. The delivery by other brokers to the firm of securities not so listed or "pay on delivery" customers will be "DK'd" or rejected. The advices from the P & S Department will usually come the day before or the evening of two days before the settlement date. The P & S Department sends a copy of this advice to the Stock Record Department for appropriate entry.

On settlement day, the cage clerk will withdraw from the available free securities those securities necessary to meet the firm's contractual delivery obligations. To the extent that securities are not available to meet delivery obligations, the appropriate entry will be noted on the documentation submitted to the cage by the P & S Department and a record will be entered in the "fail to deliver" ledger. A copy of this record will be forwarded to the Stock Record Department to reflect this position. The securities that are available for delivery will be withdrawn and delivered by messenger to either the clearing corporation or to the other side in return for the receipt of money which will be brought back to the Cashier's Department for appropriate journal entries. To the extent that the broker is requested to and has available securities to lend another broker, appropriate instructions will be generated by the stock loan section of the Cashier's Department. One copy will go to the Stock Record Department to record the loan; and another copy will go to the cage which will withdraw the securities loaned for delivery to the borrower broker for the current market price as collateral for the loan. To the extent that the firm needs to raise money by bank loan, this will be handled by the bank loan section of the Cashier's Department after being advised by the cashier of the nature and amount of the loans. The bank loan section of the cage will initiate the appropriate instructions to remove securities and pledge them at the bank in return for the loan. A copy of the instruction will be journaled to the appropriate bank borrowing journals reflecting the amount and type of loan (firm or customer collateral). Two copies will go to the cage where the clerk will withdraw the certificates noting the appropriate certificate numbers and denomination of the copies and retain one copy and will forward the certificates by messenger to the bank, transmitting the other copy to the Stock Record Department. The receipt of this money or credit will be reflected by the cashier by appropriate entries which will be journaled to the general ledger of the firm. The entry regarding the pledging of customer securities will also be forwarded to the margin clerk. When the firm decides to repay the bank loan it will reverse this procedure, and, accordingly, the cashier will draw instructions to issue the appropriate checks satisfying the indebtedness of the bank and obtaining securities pledged from the bank. The instructions will be journaled to the appropriate bank loan entries with copies to the general ledger; the messenger will deliver the funds or checks of the broker to the bank and obtain the return of the pledged securities; and the cashier will deliver them back to the cage which will place them in the vault and record their receipt with a copy of such recordation to the stock record. If the securities pledged at the bank exceed the amount which may be pledged, or if the specific securities pledged must be segregated, the appropriate instructions will be generated by the margin clerk to the cage. The cage clerk will cause a reversing entry to be made.

He will withdraw substitute collateral securities which will be delivered to the bank in exchange for the specified securities which are needed for segregation. To the extent that securities are loaned which are necessary to be segregated the margin clerk will so advise the stock loan department of the firm. They may call the current stock loan by issuing instructions to the borrowing broker to return the stock in exchange for the money which has been pledged. However, the borrowing broker has the right to wait five business days before he must return the securities. In this situation, the stock loan department may feel it more appropriate to satisfy the segregation rule by borrowing from another broker the securities which it has loaned. They will cause the necessary instructions to be issued so that the cash and general ledgers reflect the deposit of the market price as the collateral for the stock loan. Upon receipt of the securities the cage will cause the appropriate entries to be made reflecting receipt with copies to the stock borrowing section, Margin Department and Stock Record Department.

When customers of the broker pay for their purchases or other obligations to the firm, the money is received through the Cashier's Department. Appropriate instructions reflecting the receipt of this money are generated. The cash is sent to the bank and the record thereof goes to cash and general ledgers as well as the margin clerk for the appropriate entry to the individual customer accounts. Requests by customers for the return to them of their monies or transfer and delivery to them of the securities held for their account are received by the Cashier's Department. These requests are immediately forwarded to the margin clerk for authorization and approval. If authorized and approved by the margin clerk, they are returned to the Cashier's Department which will issue the instructions for and draw the appropriate check with the advices thereof to the margin clerk as well as to the detail and control cash account of the firm. For the withdrawal of securities the appropriate instructions for withdrawal from the cage and delivery to transfer will be drawn. The cage clerk will withdraw the securities from the firm's inventory reflecting their movement with appropriate records in the cage and copies to the Stock Record and Margin Departments. The securities along with the instructions will go to the transfer clerk, in the transfer section of the Cashier's Department. The transfer clerk will draw up the necessary instruction forms to effect registration of transfer and issuance of the new certificates in the appropriate names and denominations according to the instructions received and he will ascertain that the necessary signatures, endorsements and guarantees are contained with the stock certificate, and that the necessary transfer and other taxes have been paid. The Transfer Department will handle the delivery of the securities to the transfer agent and will pick them up from the transfer agent, appropriately recording these movements in its records as well as seeing to it that copies thereof are forwarded to the Stock Record Department and margin clerk. The Transfer Department is also responsible for the transfer of securities into the firm's name. Only securities in street name or otherwise negotiable form are accepted as good delivery in satisfaction of a contractual obligation to another financial institution. Brokerage firms therefore have a vital interest in seeing to it that securities they receive are readily placed in a negotiable form either in an individual's name with appropriate endorsements, or in the street name of the firm or well known financial institution.

The Stock Record Department's importance in the broker-dealer's operations is highlighted by the fact that it maintains the control record for the location and ownership of the securities which the firm either has in its possession, is owed, or has subject to its control or direction. Because of the central location of this department in the firm's operations, the Dividend and Interest Department is usually an adjunct to it. This department's responsibility is to see that the firm receives the dividends on those securities which it holds on the record date and the interest on those corporate and governmental obligations which it holds on payment date. Most broker-dealers subscribe to one or more of the major dividend and interest organizations. These organizations periodically send to their subscribers notices of all publicly announced dividend record dates, ex-dividend dates and payment dates as well as the record dates and payment dates for all interest bearing obligations which are actively traded. Upon the periodic receipt of these notices the Dividend and Interest Department will ascertain the position of the firm in those securities immediately prior to the record table. To the extent that the firm does have a position in an interest or dividend obligation the Dividend and Interest Department will ascertain whether or not it is holding the securities in the name of the firm. If not, it will issue the appropriate instructions to withdraw those securities that are not in the firm's name and have them shipped to transfer so that the firm will be the owner of record on the record date. The next step for the Dividend and Interest Department is to await notice from the Cashier's Department that it has received, the interest check or dividend—cash or stock. The amount is compared with the amount that would be due the firm based upon its record of holdings in the security. If the amount exceeds the amount due the firm, this department will create a dividends payable account with a credit balance for cash and a short position for securities and so advise the general ledger and stock record. They will research claims upon the firm by other broker-dealers or financial institutions which held securities that were registered in the firm's name at the record date for the dividends due them.

If the amount received is less than the amount which the firm claims based upon its record date holdings, a dividends receivable account debit and short will be set up with appropriate advices to the general ledger and stock record and research will be instituted by the section. They will determine if any of the firm's holdings were not registered in its name as of the record date, e.g., securities sent to transfer but which missed the record date, securities registered in a name other than the firm's and which had not been sent to transfer. These will be researched and claims back against the record owner or broker who delivered the securities will be made. Making this claim back is a very elaborate procedure requiring among other things certification of the transfer agent that the claiming firm was not the record owner as of the record date and that the firm claimed against was the record owner. The Dividend Department also verifies claim backs made against the firm. There also may be errors in payment caused by the errors in the dividend disbursing agent's records. The firm may have to claim back against the dividend disbursing agent for the appropriate amount of dividends.

The Dividend Department also processes "due bills" held by the firm or presented against the firm. A due bill may arise in several ways. If a trade was supposed to settle on or before settlement day and the ex-dividend date was at least four days before the record date and the trade failed, then upon delivery, the delivering broker would give a due bill for the dividend to the other broker. When the ex-dividend date is after the record date, due bills must be given for all trades settling after the record date.[1] In many issues where a dividend has been declared two market prices may prevail after the ex-dividend date until the payable date. One is with the dividend and the sales will require the use of a due bill. The other is without the dividend. The Dividend Department advises the cage as to those trades in which a due bill must be delivered or received in connection with the settlement. This requires a knowledge of the record dates, ex-dividend dates, and the firm's fails ledgers. The Dividend Department will make the claims on the due bills the firm has as their payable dates arrive. It will verify and process the claims made based upon the firm's due bills.

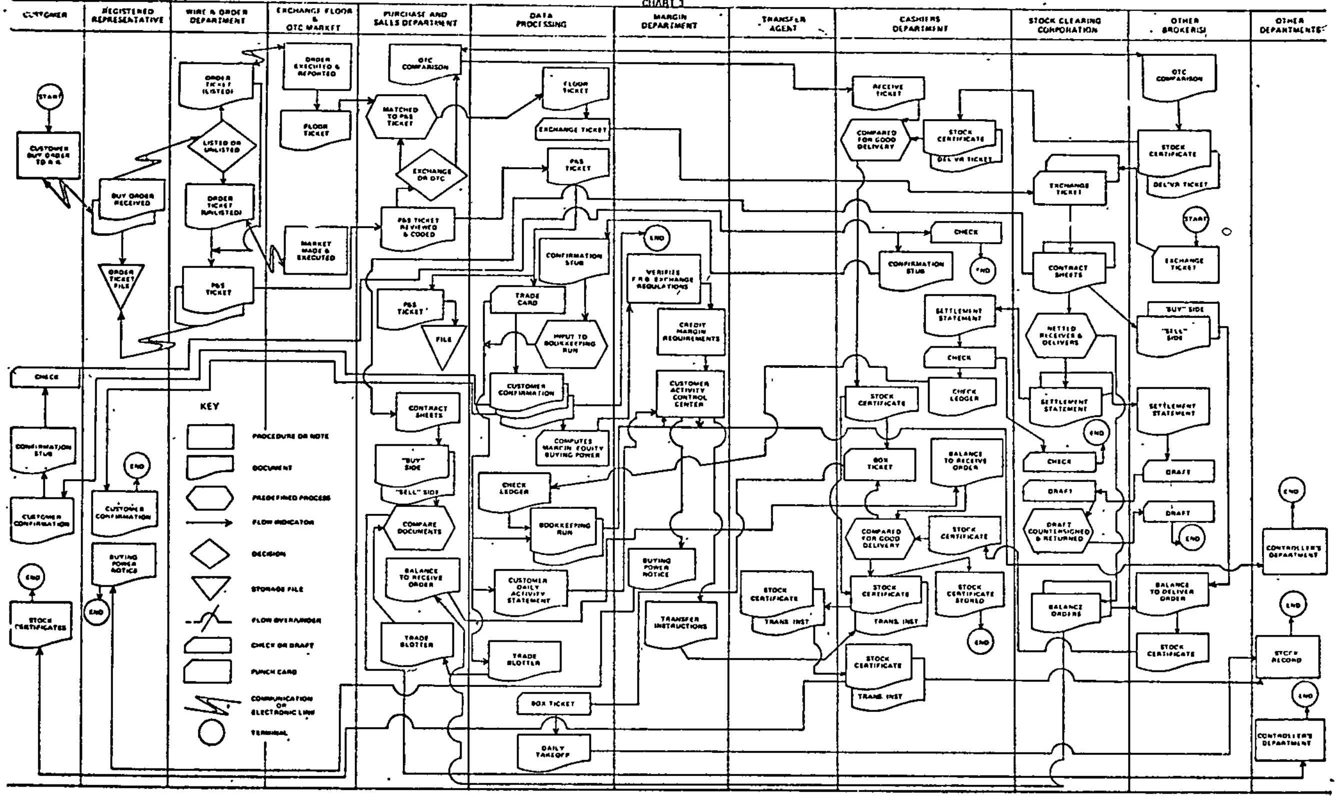
Another section of the Stock Record Department is the exchange and reorganization section. This section determines the position of the firm and its customers in securities which may be the subject of an exchange offer or reorganization, whether by recapitalization, merger or otherwise. The department also has the responsibility to keep track of securities received by the firm which have been the subject of reorganization or exchange offers and are no longer good securities in their own right, e.g., company A merges into company B in return for B stock. If after the merger, the broker-dealer receives company A stock, the exchange and reorganization section is responsible to see that the appropriate exchange of the A stock for B stock if made and that the firm holds the properly issued B stock.

The operation of an individual brokerage firm in the clearance and settlement of the securities transactions is a very complex and intricate process. The steps necessary to process and settle a securities transaction outlined above are outlined for one transaction set forth in chronological order. It must be remembered that at any one point in time many transactions with respect to trades on many days are being processed. Because the multiplicity of steps that must be taken with respect to each transaction, the number of transactions for any given date, and the number of various days that are being handled in any one point of time by each one of the various departments the possibility for confusion and error is manifold.

[1] The Rule 10b–17 requirement of 10-day advance notice of record dates should alleviate the problem of an ex-dividend date being set after the record date which heretofore resulted in the trade organization's lack of knowledge of the record date.

APPENDIX H

GENERAL FLOW OF A TRANSACTION
CHART 1



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