1971

TO: HON. LOUIS J. LEFKOWITZ
Attorney General of the
State of New York

FROM: DAVID CLURMAN
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in Charge Bureau of Securities and
Public Financing

A Report On

THE AUDITORS OF WALL STREET

A report made pursuant to Article 23-A of the General Business Law of the State of New York commonly referred to as the Martin Act.

New York, New York
July , 1971

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PRELIMINARY STATEMENT

At the end of January 1971, as the result of complaints received by this office, you requested that the Bureau headed by the undersigned, the Bureau of Securities and Public Financing of the Department of Law of the State of New York, conduct an inquiry into auditing practices by accounting firms with reference to their audits of member firms of the stock exchanges that offer and sell securities to members of the public in this State.

This investigation has been conducted for a period of approximately six months under the provisions of Article 23-A of the General Business Law of this State, and more particularly Section 352 thereof. While this inquiry continues because of important material which has come to our attention necessitating further investigation, it is felt that exigencies in the securities markets necessitate an early report to be issued at this time on important findings that have already been made.

SPECIFIC CONCLUSIONS

1. The surprise audit is the chief device of the independent accountant-auditor of securities firms. It is a farce, with little surprise to anyone. It should be abolished, with really surprise checks on certain securities held by brokers being made in addition to regular, annual audits. Regular annual audits would permit for the first time profit and loss statements to be issued as well.

2. Independent accountant-auditors have been part of an arrangement whereby the public is told a tightly lidded story about the financial condition of broker-dealers, with limited availability of information filed elsewhere that tells a more complete story. While the motivation for this dual approach is the promotion of public confidence in the fiscal responsibility of broker-dealers, the investing public has been unreasonably kept from important information.

3. Accounting techniques of independent accountants, abetted by minimum standards of regulatory and self-regulatory rules, have cloaked by sophisticated language, and inattention to dangerous possible consequences, the

regular and systematic and habitual misuse and misappropriation as collateral or otherwise of fully-paid securities and other custodial deposits of members of the investing public.

4. The stated opinions of auditors, contained on balance sheets of brokers prepared for customers to peruse have, in many instances, been deceptive, avoided essential footnotes, and been aimed more at showing a purported good financial health of a client rather than a true financial condition consistent with the auditor's responsibility. We have wondered whether some accounting firms were hired as doctors rather than auditors.

5. By failing to forewarn the investing public, and the market place in general, of the beginning of faltering finances of broker-dealers, the auditing profession has often been able to hide problems until their intensity became overwhelming, with the resulting public harm.

6. By the end of our initial study, we could without hesitation conclude that far too much management influence pervaded the auditing function in the securities business. This element constitutes the greatest possible danger to the investing public and the securities market

place. It is our recommendation that auditors no longer be hired by securities firms, but rather by an outside agency. We seriously question whether the present posture of organized exchanges would permit these self-regulators to make such choices.

7. Certain other individual situations posing serious violations of current law involving particular accounting firms and specific brokers are being probed by our staff. These cases, because of their special nature, will be handled under regular investigative procedures with results unannounced until a determination is reached as to the extent of official action necessary.

GENERAL CONCLUSIONS

Integrity in the securities markets must primarily be based on the good character of its business promoters. Besides selling securities as principals, the broker-dealer performs the fiduciary function as customer's agent, and the banking function of custodian of customer's securities or cash funds.

While self-regulatory bodies such as the New York and American Stock Exchanges have adopted protective rules, and some government agencies have regulatory powers, it is primarily the independent accountant-auditor on whom rests primary, regular responsibility for projecting the financial condition of broker-dealers to members of the investing public. Regretfully, for reasons set forth in this report (and others to follow) it is our feeling that this responsibility often has not been met in the recent past.

We believe a complete re-evaluation of auditing standards and procedures and accepted accounting principles must be made by the accounting and regulatory groups. In the absence of swift changes that would halt the practices disclosed by this report, we would recommend stringent state legislation that would protect the New

York investing public and promote the healthful growth of the securities industry which is centered in our State. If required, such recommendations will be made to the next Legislature in January 1972.

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INTRODUCTION

In early January 1971 in accordance with instructions from the Attorney General, this Bureau undertook an inquiry into the accounting practices and financial reporting of securities brokers by independent public accountants. The inquiry was in large part generated by hundreds of complaints from members of the public as a result of the sudden demise of several brokerage houses.

The collapse of these brokerage houses forced customers, in many cases, to seek the return of their monies and securities from duly appointed liquidators, trustees in bankruptcy, and receivers. These customers, at best, have been deprived of their securities and cash for substantial periods of time; and, at worst, may sustain partial or complete losses of their assets.

The inquiry was designed to determine whether or not financial reporting in the brokerage industry was sufficiently adequate to give the public, generally, and brokerage customers, particularly, some forewarning of impending disaster. A characteristic of most financial statements prepared for customers, conveys the overall impression that the financial health of the firm is

satisfactory. The financial reports, which in practically every case consisted of a single balance sheet, indicated clearly to anyone, even experienced accountants, that sufficient assets were available to meet the liabilities; and yet, in many cases, very shortly after such apparently satisfactory financial statements were issued, companies were forced to merge, consolidate, liquidate or terminate business because of financial inadequacies.

Our inquiry was implemented by the examination under oath of scores of witnesses including cashiers, comptrollers, partners and executives of member firms, and senior staff members and partners of accounting firms who engage in brokerage accounting. Over one thousand questionnaires were also distributed, compiled and analyzed. These questionnaires were aimed at three basic areas:

1. A broker inquiry questionnaire, containing 77 questions and subdivisions thereto, directed to approximately 350 New York Stock Exchange member firms, which conducted business within the State of New York.

2. A broker customer inquiry questionnaire, containing 64 questions, addressed to members of the general investing public and special control groups such as accountants, economics professors and customers

of firms which had ceased operating or were liquidating.

3. A brokerage accountants inquiry questionnaire, containing 52 questions and subdivisions thereto, addressed to members of the accounting profession who were identified by their employers as having been engaged in brokerage accounting assignments.

After approximately six months of examination, investigation, compilation, and review, certain preliminary conclusions have emerged concerning brokerage accounting and financial reporting, customs and procedures as applied to the brokerage industry, and related matters.

The inquiry was conducted by this Bureau under the authority of Article 23-A of the General Business Law of the State of New York, which permits the Attorney General in his discretion, to make investigations and inquiries in the public interest and to determine whether or not fraudulent practices are being committed in the securities business.

THE AUDITORS

Most of the audits of New York Stock Exchange clearing members having retail customers, are conducted by the "Big 8" accounting firms and a handful of smaller firms who specialize to some degree in brokerage auditing. The bulk of the largest clearing brokers in the industry are audited by those firms comprising the "Big 8".

In our survey of 350 New York Stock Exchange member firms, 182 were identified as doing their own clearing. Of these, 114 were serviced by the "Big 8" accounting firms. In the aggregate, at time of the survey, those 114 brokers held 11 billion dollars in assets (averaging $97 million each), and have together a total of 5 1/4 million customers, serviced by 31,000 registered representatives.

Approximately 800,000 customers of these firms were described as residents of New York State. These customers had the availability of 7,700 registered representatives in New York.

Combined, the 114 brokers have 40,000 back office personnel, 27,000 of whom are located in New York and operate 1,800 branch offices throughout the country of which 270 are in New York State.

By custom and usage, the term, "Big 8" refers to the eight largest accounting firms in this country. In alphabetical order, they are: Arthur Andersen & Co.; Ernst & Ernst; Haskins & Sells; Lybrand, Ross Brothers & Montgomery; Peat, Marwick, Mitchell & Co.; Price Waterhouse & Co., Touche, Ross & Co.; and Arthur Young & Co. If size alone is a criterion, certainly the "Big 8" firms cannot but fail to be impressive. Illustrative of the dimensions involved are the figures which follow, obtained from responsible representatives selected by the accounting firms themselves. A representative firm has 300 partners in the United States with affiliations of greater or lesser degree with 130 accounting offices located abroad. The witness supplying this information was a partner but he does "not recall the gross revenue" of his firm, though he believes it ranks with other members of the "Big 8".

In another instance, the witness was a firm manager, the highest employee level, usually second in command immediately below a partner. He was able to state that his firm had about 350 partners and 5,000 professional members, of whom 500 are managers. The gentleman was also unable to supply any information as to the total gross revenue of the firm.

Another firm was described by one of its partners as having nearly 11,000 professional personnel, of whom 700 are partners of participating principals (individuals not C.P.A.'s, but enjoying select executive status). This partner was able to estimate the gross annual revenue of his firm at approximately $200 million.

A partner of another firm testified to the employment of approximately 6,000 people, with 300 partners and almost 200 offices throughout the United States and foreign countries. He indicated that the gross annual revenue of the firm was in the order of $100 million.

Another "Big 8" firm has about 4,000 employees with 70 offices in the United States and other offices and affiliates in Canada, South America, Asia and Europe. Although the witness from this firm was a partner primarily engaged in administrative and executive office functions, he was unable to estimate the total annual gross revenues of his accounting firm. He concluded that the firm has 15,000 clients.

Another firm surveyed has 450 partners throughout the United States, and 5,500 professional personnel, but the partner providing this information was similarly unable to indicate the annual gross revenues of his firm.

The partner of a seventh firm indicated that the firm employs about 10,000 personnel on a worldwide basis and has gross revenues of about $200 million. In New York, the firm has about 1,000 professionals, including partners. The witness stated that brokerage audits and accounting constituted a mere 1% of the total activity of the firm.

For a last example we cite a firm also international in scope, with about 10,000 professionals including partners. A partner of this firm estimated that about 1,000 persons, including 50 partners are employed in New York. This partner declined to supply any information as to the gross annual revenues of his firm, or estimate where this firm stood with relation to the "Big 8", on the grounds that all he had ever heard regarding revenues were rumors or approximations. However, he did state that with regard to revenues, the brokerage practice of his firm is in the neighborhood of 1%.

From the information made available to us during the course of our inquiry, we estimate that the gross annual revenues of the "Big 8" approximates $900,000,000.

One hundred and ten of the clearing brokers audited by the "Big 8" answered questions relating to the

total audit fees charged by such accountants. The total fees charged for the past three years are as follows:

1968 - $ 9,087,000
1969 - 10,102,000
1970 - 9,493,000

Our analysis also indicates the obvious relationship between the size of the fees charged and the condition of the back office. In most cases where back office problems were great, the work performed and the fee charged were proportionately higher. It does not appear that the upward inflationary trend of the last few years has directly affected the accounting practice as it related to billings of brokerage audits.

At times, when the back office problem appears most acute, the brokers, as a cost cutting measure, are sometimes forced to reduce staff, further compounding the work of the auditors, resulting in a more costly audit. In at least one case brought to our attention, an auditor was forced to discontinue the audit because of insufficient back office help. The audit was never completed and eventually the firm was declared a bankrupt.

When the accounting services are most needed to insure disclosure of the financial condition of a broker,

the auditors may be severely frustrated at the volition of the client by lack of staff.

Some provision must be made for an outside agency to insure prompt completion of audits when trouble develops. Any additional funds expended by the industry or government to insure completion on a timely basis would be well spent and perhaps save considerable sums which might otherwise be needed in some form of customer assistance.

In our survey, only 68 brokerage firms, consisting of 48 partnerships and 20 corporations, all of whom do their own clearing, were audited by accounting firms other than the "Big 8". The total assets of these brokerage firms was $4,630,807,000. As a group they have 557,000 customers in the United States, 234,000 of these customers are in New York State. These firms have 4,000 registered representatives overall, 3,000 of whom are in New York State. Their back office employees total 8,200, of which 7,700 are employed in New York State.

One factor separating the "Big 8" accounting firms from their smaller colleagues is the sheer size of the man-power required in performing brokerage house audits. A key element of the audit is the taking of

full control over, and counting the securities on the premises of the broker. The accounting firm engaged to do the audit must arrange to have its personnel stationed in sufficient numbers to simultaneously control all places where securities are kept. In the case of the large brokers, this usually requires hundreds of accountants.

The "Big 8" accounting firms by virtue of their large size are able to draw upon large pools of man-power to satisfy the securities count aspect of the audit. In the case of medium and smaller firms, the man-power demand alone prevents them from undertaking audits of large and medium size brokers. Where attempts have been made to undertake a large audit, these firms have had to rely on the employment of part-time and temporary help. Due in part to labor market fluctuations and the exacting requirements of the work, it would appear inadvisable to allow an undermanned staff to attempt this singularly important phase of the audit.

Witnesses associated with medium size and smaller accounting firms have indicated that they do not undertake larger brokerage audits, not for lack of knowledge or skill, but almost solely for the reason that they cannot regularly muster sufficient man-power to meet the securities count requirements mentioned above.

In contrast to the "Big 8" accounting firms who have indicated that brokerage audits constitute approximately 1% of their total activities, brokerage audits conducted by the medium size and smaller accounting firms often constitute a relatively high percentage of their practice. For example, in one medium size firm, brokerage audits accounted for about 60% of its total revenue. In the case of one smaller accounting firm, brokerage audits constituted almost 100% of its practice. There are indications that the largest accounting firms are not necessarily the most expert in this field, but that their size places them in a unique position to service large brokerage houses.

It is no surprise, in view of the information supplied, that reports of some of the medium sized and smaller accounting firms provide more analysis and detail than reports of the larger firms. For example, a smaller accounting firm undertakes as a matter of course, to report upon the valuation of securities held in segregation or for safe-keeping as a custodial obligation of the broker, unlike the general approach of most large accounting firms.

Indeed, General Instruction #B2, of the New York Stock Exchange Set of Audit Instructions specifically eliminates the necessity of the auditor to make such a valuation. Such rule states:

> "The valuation of customers' securities in segregation or safekeeping need not be included in the answers".

The Attorney General's questionnaire requested that the total amounts of fully paid securities held in segregation and safekeeping be given. But only 46 of the clearing firms were able to give any figures on fully paid segregated securities. Such respondents estimated the amount of such securities at $11.4 billion. A total of 39 firms reported $945 million as being held in safekeeping. The balance of the clearing firms were unable to answer the question. It is incredible that the custodian is not obliged or able to indicate the extent of his custodial obligations.

THE SURPRISE AUDITS ARE NO SURPRISE

The cornerstone of financial reporting in the brokerage industry is based on the so-called surprise audit, which is required once in each calendar year of members of the New York Stock Exchange doing any business with other than members or member organizations of the Exchange. Rule 418 of the New York Stock Exchange Rules requires that each member firm doing business with the public undergo an annual certified audit and examination without prior notice to the broker. This, the "surprise audit" requirement, was apparently designed to instill public trust and faith in the brokerage industry.

Prior to each January 1st, every brokerage firm within the purview of Rule 418 engages its own independent auditor and accordingly notifies the New York Stock Exchange as to the name of the independent public accounting firm which will perform the audit of its books, records and affairs during the ensuing year as of a particular date to be chosen by the auditor.

The accounting firm so engaged then transmits a letter to the New York Stock Exchange indicating its designation as the auditor for the particular firm and advises the Exchange during which third of the year it

expects to make its surprise examination. This information is required to be confidential between the auditors and the Stock Exchange.

Therefore, the client has no official knowledge as to which third of the year the auditors have chosen which hopefully preserves the element of surprise. Some element of the surprise, however, is diminished by the fact that in each of the other two thirds of the year, not designated for the surprise audit, the New York Stock Exchange usually requires a special report. This report is similar to the report rendered by the independent auditors, except that it is requested of and usually prepared by the stock broker. This report is not required to be audited. It follows, therefore, that if a brokerage firm is required to furnish a special report in each of the first two thirds of the year, it knows that it will be audited in the last third of the year.

In addition, accountants engaged in the brokerage accounting field have testified during our inquiry that the New York Stock Exchange permits a great amount of flexibility in setting the exact date because it is recognized that the accounting firms have other clients whose acitivites impose different and unavoidable

time obligations for service, such as tax work and calendar year end audits.

The present system of surprise audits impedes uniformity with regard to reporting on an annual fiscal year. Indeed, accountants have testified that the intervals between audits may vary from 9 months to 22 months. They have also testified that profit and loss statements for the firm are not audited because the unequal periods would make the figures relatively meaningless. Consequently, the excuse commonly given for not furnishing audited profit and loss figures to the customers of brokerage houses, as well as to the regulatory and self-regulatory bodies is that the surprise audit causes unequal fiscal periods. This factor emerges as an inherent evil of the present system. The elimination of the surprise audit requirement would eliminate this excuse.

However, it is noted that there is no present requirement that certified profit and loss statements be prepared as part of the audit or otherwise. Naturally, unless required, the client would be loathe to pay for extra work. Several accountants have testified, however, that a certified profit and loss statement could and should be prepared, regardless of the irregular periods between audits.

Our investigation has revealed that whatever salutary benefits may accrue from unannounced examinations, such benefits are diminished because the element of surprise is often lacking in practice. This is caused by several factors. One factor already mentioned is the New York Stock Exchange special report requirement. A second factor is that the logistics of conducting an audit, especially among the large brokerage houses, tends to eliminate surprise and secrecy. The initial phase of the auditing procedure requires that the auditors take complete control over the securities and the counting of said securities. This count requires, in some cases, hundreds of people working together at the same time and place. To accommodate such a large audit staff, advance planning and arrangements are required which inevitably afford prior notice to the client and its staff. Our inquiry reveals that sometimes five days prior to the audit date, a few men of the audit staff appear on the premises of large brokerage firms. The broker then prepares desk space, rooms and other paraphernalia for the use of the auditing staff. The broker may also alert his work force that over-time work may be necessary over the weekend. The staff accountants, answering our broker accountants inquiry, have indicated that the advance

notice to them varies from one day to as much as nine months. In any event, the surprise audit rarely begins in an atmosphere of surprise.

An analysis of our Broker Inquiry Questionnaire, indicates that a third factor diminishing the element of surprise is that the overwhelming majority of brokerage audits are conducted between March and October. The auditor, due to the press of other business, such as the preparation of tax returns and the calendar year end audits, for the most part schedules his brokerage audits in months other than November, December, January and February.

In addition, some accountants have testified that they try not to schedule audits for the same firm in the same third of the year as in the previous year. Since brokers know of this practice, if they were audited in any month of a particular year, they can make an intelligent guess as to the most likely period of the next audit. This effort to schedule succeeding audits in a different third of a year is not based on any rule, but is a practice engaged in by some accounting firms to attempt to bolster or preserve whatever surprise aspect can be salvaged.

Despite the foregoing practice by some auditors, an analysis of the broker inquiry questionnaire reveals that audits by other firms are not only conducted in the same third in succeeding years, but often in the same month.

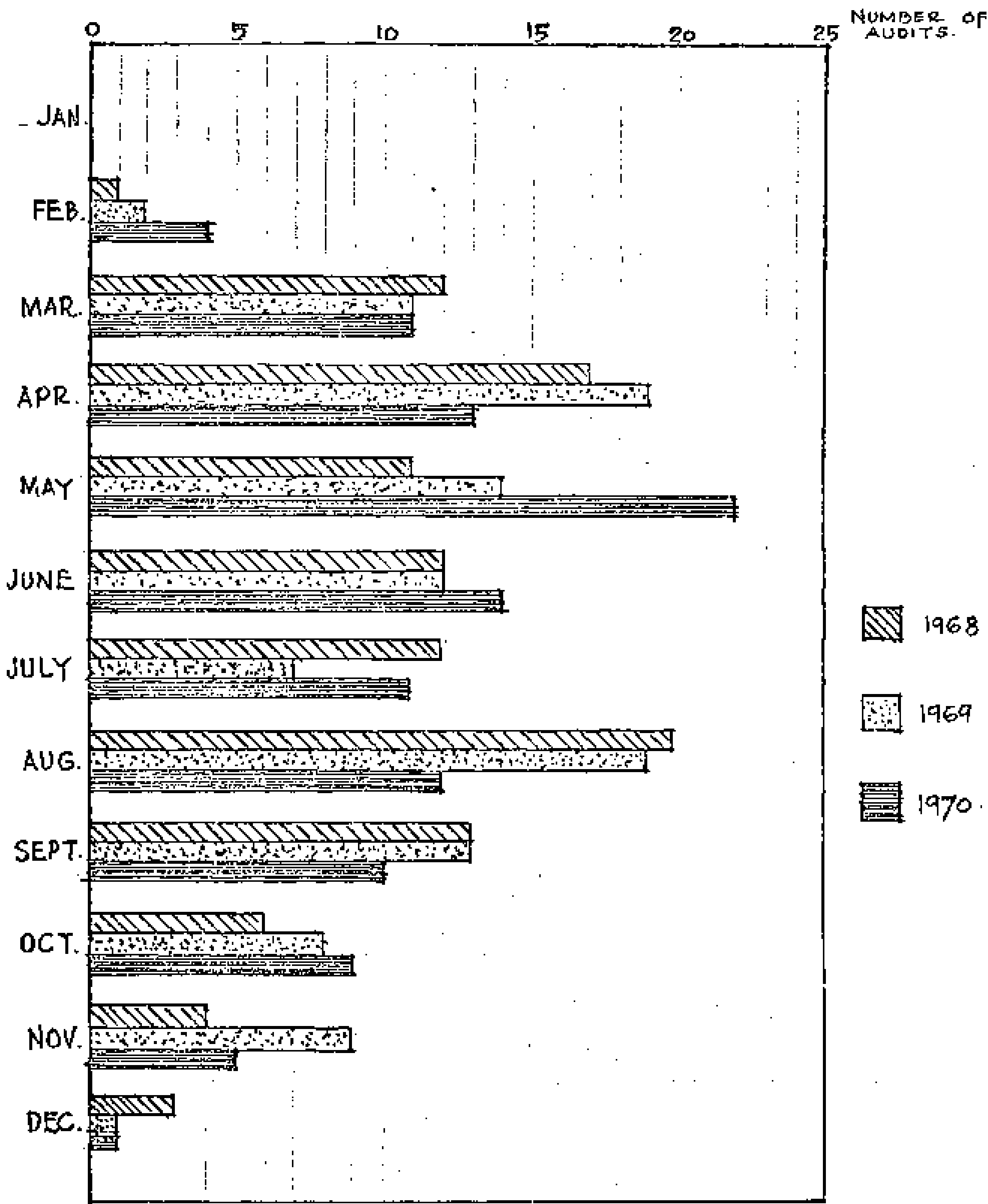
Further, our investigation reveals that the audit date within any month of stock brokers conducting a retail business coincides with the date of their monthly customer's statements. Thus, with respect to an audit date for a month in which the surprise audit is conducted, the date is actually fixed. Such brokers are little concerned with the possibility of an audit in the middle of the month. To that extent, the element of surprise is also minimized.

Furnished below are graphs indicating months during which surprise audits were conducted during the years 1968, 1969 and 1970. The graphs illustrate the uneven distribution of audits during the year.

See Chart No. 1
See Chart No. 2

ILLUSTRATION CHART NO. 1

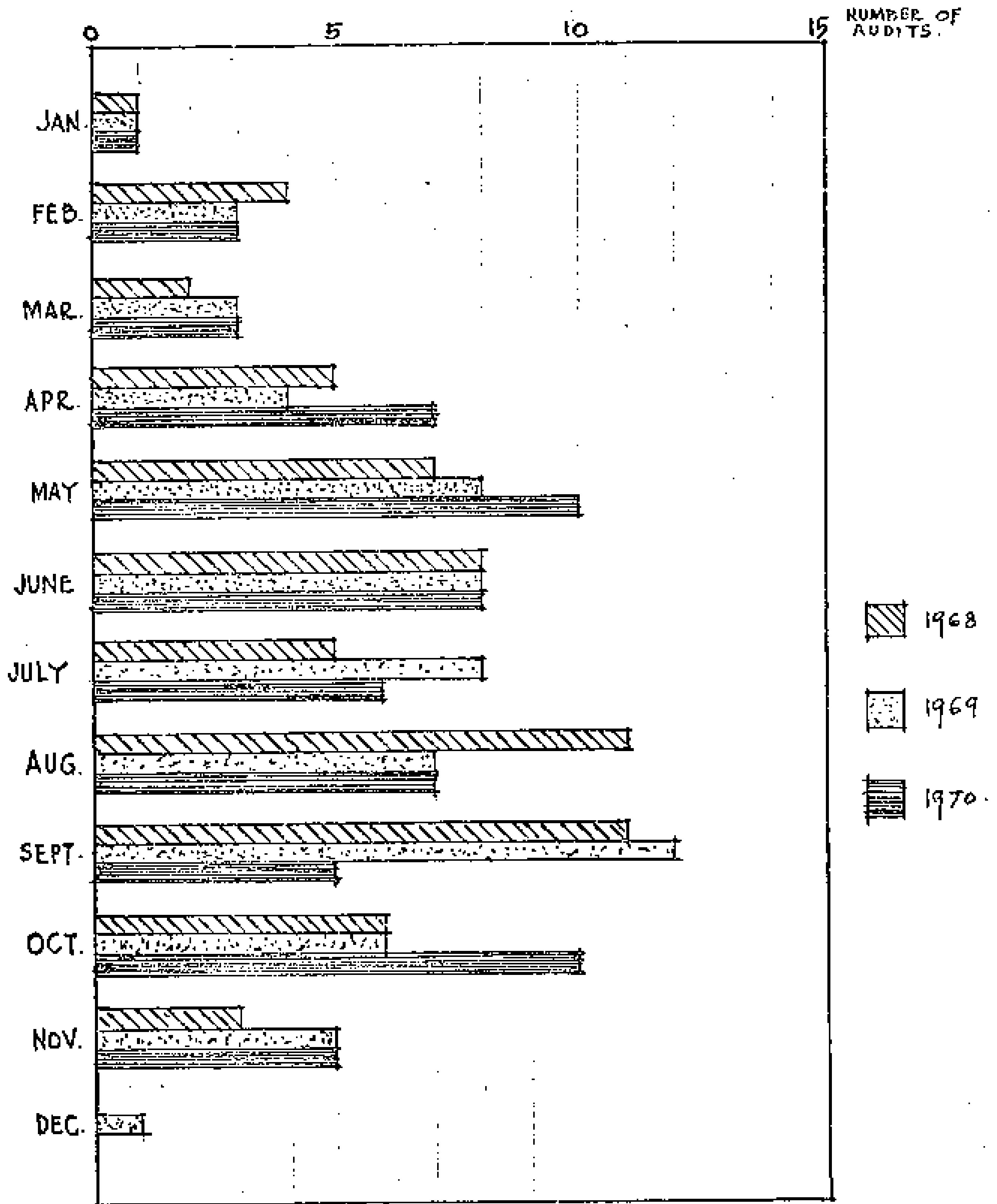
MONTH ENDINGS ON WHICH CLEARING STOCK BROKERAGE CLIENTS OF THE "BIG-EIGHT" ACCOUNTING FIRMS HAD THEIR SURPRISE EXAMINATIONS IN 1968, 1969, 1970.



SOURCE - STUDY OF ACCOUNTING PRACTICES OF SECURITIES BROKERAGE FIRMS BY ATTORNEY GENERAL OF NEW YORK 1971.

ILLUSTRATION CHART NO. 2

MONTH ENDINGS ON WHICH CLEARING STOCK BROKERAGE CLIENTS OF ACCOUNTING FIRMS <u>OTHER</u> THAN THE "BIG-EIGHT" HAD THEIR SURPRISE EXAMINATIONS IN 1968, 1969, 1970.



SOURCE-STUDY OF ACCOUNTING PRACTICES OF SECURITIES BROKERAGE FIRMS BY ATTORNEY GENERAL OF NEW YORK 1971.

If the audit scheduling were on a true surprise basis, each working day of the year would have an equal chance for selction. A graph of such a situation would result in bars of almost equal length. The current practice severly limits the area of selectivity and allows the broker to make an educated guess as to the date the unannounced audit actually takes place. It follows, therefore, that knowledge of the audit date, however obtained, may afford the opportunity for certain unscrupulous brokers to use such advance information to cover up material irregularities and illegal transactions which might have been uncovered by a true surprise audit. Certain situations revealed during the course of our investigation warranted further study, which is now being pursued by our staff.

It is our recommendation that if the present system cannot be perfected to insure a truly surprise audit, the entire system should be replaced in favor of regular periodic audits bolstered by a program of surprise securities counts by external personnel.

At the very least the audits should be evenly distributed during the year. Each month should have an equal chance of being selected. If the independent

auditors cannot provide this service to the brokerage industry, then they should not undertake such assignments. It should be incumbent upon the New York Stock Exchange to assure the equal distribution of audit dates.

The accountants interviewed by our staff during the course of this study generally were neither alarmed nor shocked by any suggestions calling for the elimination of the surprise audit. Many felt that audits conducted on a fiscal year basis together with adequate surprise external security counts would be at least as satisfactory as the current method of reporting and probably superior.

In the questionnaire addressed to accountants engaged in brokerage accounting the following question was asked: "In your experience, does the concept of surprise audits of stock brokers, as requested by the New York Stock Exchange, have validity as opposed to regularly scheduled audits?"

Typical replies are as follows:

(a) "I feel that no purpose is served by a surprise audit as opposed to a regular review of the firms internal control."

(b) "In reality, the brokerage house knows a surprise audit is to take place because they must tell employees that they will be working longer, so no one is surprised."

(c) "Most brokers can judge when a surprise audit will occur and therefore most surprise benefits are lost. I would prefer an annual audit with surprise security counts and confirmation during the year."

(d) "However, brokerage house personnel do seem to know when the audits will occur. This is due in part to timing of prior year audits and the time demands placed on C.P.A. firms as related to their busy season."

As to publicly held brokerage firms who now must comply with the statutory requirement for full financial disclosure on a fiscal year basis, the need for a surprise audit in the traditional sense might be eliminated without any loss in financial reporting and knowledge if surprise external counts are retained. At present such brokerage firms are subject to two audits, one for the fiscal period and one on a surprise basis.

Whatever advantages presumably accrue by requiring a surprise audit have virtually been completely

eroded in view of the fact that the actual surprise is minimal. Indeed, we have seen an example of what can happen even with a surprise audit. In the case of one member firm we uncovered a theft by an employee of that firm which took place immediately after the surprise audit. The thief, unafraid of internal counts due to his position, relied on the knowledge that there would be no external count of securities for at least nine months. Perhaps with regular periodic audits and true surprise external securities counts which could be expected at any time, (even within a week of each other), this particular theft and perhaps other thefts could have been and will be prevented. To preserve the present system with its serious flaws simply tends to preserve a false sense of security.

The surprise audit should not be viewed as a sacred cow, unalterable and holy. The startling growth of the securities industry has rendered obsolete many of its security handling and administrative practices. Perhaps the surprise audit, too, should be carefully re-evaluated.

DIVERGENCY BETWEEN PUBLIC AND PRIVATE REPORTS: THE ACCOUNTANT'S ROLE

After the field work has been accomplished by the individual auditors and the work papers and schedules have been prepared, the summary figures flow into various reports which fall into two general categories: those addressing themselves to regulatory and self-regulatory bodies and those addressed to the public at large. The report addressed to the regulators is embodies in a document entitled, "Answers to Financial Questionnaire". (Those brokers who are not members of the New York Stock Exchange prepare a similar report for submittal to the Securities and Exchange Commission.)

However, a separate and different report is prepared for public distribution by the accountants as of the same date, which undertakes to state the financial condition of the broker. This report generally consists of a one-page Balance Sheet accompanied by a brief "Certification Letter". It is this report that is sent to customers to satisfy the requirement of the New York Stock Exchange that customers be supplied with an annual certified statement of financial condition.

In the case of those brokers which have gone public, an additional report on a fiscal year basis is prepared for submission to its investors. At the present time, there are few publicly owned brokerage firms. However, the nature of this type of report is very similar to the annual reports encountered in connection with reports rendered by publicly held firms listed on the various stock exchanges or otherwise subject to the disclosure requirements of the Securities and Exchange Commission. The most outstanding aspect of such latter reports to investors of brokerage firms is that there is a relatively complete financial reporting. Both a Balance Sheet and a Profit and Loss Statement, covered by the accountant's certification are provided. In addition, comparative figures are given for previous periods.

It is interesting to note, however, that in the case of at least one publicly held broker, the financial report rendered to the investors is a different report than that rendered to the customers. In the case of the reports to the customers only a brief Balance Sheet is provided. On the other hand, the investor shareholders of the brokerage firm are afforded a more elaborate financial report which includes Profit or Loss figures

and comparative statements. It is interesting to contrast the information afforded to the individual who merely does business with the broker as compared to the individual who has an equity investment with the broker. In the case of the former, he is deprived of much information which will enable him to decide whether or not to continue to carry his account with the brokerage firm and concomitantly his feeling of confidence in their ability to handle his transactions and safeguard his cash and securities. On the other hand, the investor is given a greater amount of information upon which he can intelligently make a decision as to whether or not to maintain his equity position in the brokerage firm or to increase it or to eliminate it. Such inconsistency reflects the greater protective shield given to the public by stock issuers than by securities brokers and dealers.

There is no doubt that the customers of those brokerage firms that have failed within the past three years were not adequately apprised by the submission of the usual statement of financial condition of the difficulties that these firms were encountering which eventually led to their liquidation or other cessation of business. If the concept of full and fair disclosure is a valid one, with respect to the sale of securities

to the public by companies desiring new capital, then there is no reason not to apply this concept to the broker with which the public deals.

We have set forth below a table (See Table I) which contrasts the information that was given to the public by those brokers who have been forced to close their doors during the past three years due to financial inadequacies and the information which the New York Stock Exchange had available to it by reason of more detailed requirements of reporting such as the amount of net capital and the ratio of aggregate indebtedness to net capital.

For example, in the case of Amott Baker & Co., the last audited statement of financial condition before its demise indicated that its total assets of $6,769,000 exceeded its total liabilities of $5,530,000 for a net worth of $1,239,000. This is what was told to the client of the broker. So far as the customer knew, he was advised that his broker's financial condition was quite adequate. However, the New York Stock Exchange was not obliged to rely on such figures. It computed the net capital as of the same date from the more detailed information in the "Answers to Financial Questionnaire" submitted by the

broker to be only $364,000 and a ratio of aggregate indebtedness to net capital to be 1527%. The public was not apprised of the serious financial status that this company was facing. As a matter of fact, in the 1970 annual report of the New York Stock Exchange it is related that this firm's financial condition eventually was deteriorated to such an extent as to require $1,870,000 of funds from the customers' assistance program. Not only had the net worth effected by the last audited statements vanished, but additional funds in large quantities were required to prevent losses to the unsuspecting public. (See Table I, on the following page)

TABLE I

:ABLE OF LAST PUBLISHED AUDITED STATEMENTS OF FINANCIAL CONDITION OF SECURITIES BROKERS TERMINATING BUSINESS, 1968-1970

NAME OF BROKER	DATE OF FINANCIAL STATEMENT	FIGURES FROM LAST PUBLISHED AUDITED STATEMENTS OF FINANCIAL CONDITION			FIGURES FROM NEW YORK STOCK EXCHANGE RECORDS AS OF SAME DATE AS LAST PUBLISHED AUDITED STATEMENTS.		ESTIMATED COST EXPECTED-NYSE CUSTOMER ASSISTANCE PROGRAM AS OF JAN. 4, 197
		ASSETS	LIABILITIES	TOTAL EQUITY OR NET WORTH	NET CAPITAL	RATIO OF AGGREGATE INDEBTEDNESS TO NET CAPITAL	
:IOTT, BAKER & CO., INC.	8/31/67	6,769,000	5,530,000	1,239,000	364,000	1527%	1,870,000
:AERWALD & DeBOER	4/25/69	8,153,000	6,444,000	1,709,000	291,000	2213%	900,000
:LAIR & CO., INC.	9/26/69	108,485,000	85,502,000	22,983,000	5,134,000	1643%	14,900,000
:EMPSEY-TEGELER & CO., INC.	6/1/69	157,346,000	121,227,000	36,119,000	4,713,000	2169%	16,000,000 (1)
:USZ-SCHMELZLE & CO., INC.	4/30/69	5,918,000	4,144,000	1,774,000	312,000	1441%	325,000
:OODBODY & CO.	9/28/69	417,212,000	363,500,000	53,712,000	17,256,000	1980%	30,000,000
:REGORY & SONS	10/27/68	136,201,000	121,068,000	15,133,000	(2)	(2)	5,940,000
:AYDEN, STONE INC.	8/3/69	242,773,000	200,786,000	41,987,000	10,880,000	1728%	9,800,000
:LEINER, BELL & CO., INC.	10/31/69	64,895,000	50,583,000	14,312,000	5,085,000	957%	0
:cDONNELL & CO., INC.	10/31/68	139,525,000	125,074,000	14,451,000	2,869,000	3992%	8,977,000
:EYERSON & CO., INC.	5/29/69	8,176,000	6,166,000	2,010,000	522,000	1324%	250,000
:RVIS BROTHERS & CO.	8/31/69	37,368,000	29,742,000	7,626,000	2,565,000	1104%	3,900,000
:ICKARD & CO., INC.	10/31/66	4,857,000	3,816,000	1,041,000	245,000	1558%	169,000
:HARLES PLOHN & CO.	4/29/70	20,741,000	18,565,000	2,176,000	(898,000) (3)	INCALCULABLE	0
ROBINSON & CO., INC.	6/27/69	16,260,000	13,118,000	3,142,000	(131,000) (3)	INCALCULABLE	1,300,000
TOTALS		$1,374,679,000	$1,155,265,000	$219,414,000			$94,331,000

(1) Accountant's report discloses $17,000,000 instead of $16,000,000

(2) NYSE unable to supply data.

(3) Parentheses indicate a deficiency in net capital.

SOME DIFFICULTIES IN THE AUDIT

If the broker is in serious financial difficulty, or if the broker is unable to handle its volume of business in an efficient manner, or if its internal procedures are breaking down, the public should be informed of this information before entrusting its monies and securities to such broker.

The back office of many firms has been in turmoil for the past three years. Responses to our questionnaire indicate that the rate of turnover of key back office personnel has been phenomenal.

TABLE II

LENGTH OF SERVICE OF KEY BACK OFFICE PERSONNEL

	0 - 1 Year	1 - 3 Years	Over 3 Years
Head Cashier	33	58	91
Head Margin Clerk	38	54	80
Operations Manager	32	57	92
Comptroller	30	49	96

Our inquiry has discovered as illustrative of such back office turmoil that it is not uncommon for the personnel in the back office to forge customers' names on certificates to speed the processing of securities transactions. Further, a notary public contrary to law notarizes documents for customers that he never sees. Stolen certificates are redelivered for authentication to the very back office from which they were stolen. When the thief attempts to negotiate the stolen certificates, the back office proceeds to authenticate and redeliver out their own stolen securities without knowing they are dealing with their own stolen stock.

Brokers have reported to us that $21,744,000 worth of securities have been stolen from them during the past three years. This figure represents 41 brokers who reported such losses.

The magnitude of the back office problem and the general failure of the brokers to maintain some semblance of control over the securities entrusted to them is exemplified by the answer to a question propounded in our broker questionnaire asking what amounts of securities were reported as missing or the subject of differences in financial statements issued by auditors as reflected in Table III.

TABLE III

REPORTED DIFFERENCES IN SECURITY COUNTS

REPORTED BY AUDITORS FOR CLEARING BROKERS

MEMBERS OF NEW YORK STOCK EXCHANGE (182 in Group Queried)

Year	Number of Respondents Reporting Differences	Long Valuation of Securities	Number of Respondents Reporting Differences	Short Valuation of Securities
1968	150	$208,276,000	150	$97,312,000
1969	157	$155,017,000	159	$89,219,000
1970	163	$ 44,989,000	166	$52,224,000

THE NEED FOR MORE FINANCIAL INFORMATION

Except for the few brokerage firms capitalized with freely transferable securities, the customers of brokerage firms are typically provided only with a statement of financial condition which is in essence a balance sheet. Indeed, out of the 182 clearing firms that responded to us in our inquiry, a mere four indicated that they supplied profit and loss statements to customers and 178 indicated that they did not. Further, only 23 out of the 182 brokers indicated that any information as to profitability was given. This statement of financial condition, of course, speaks only as of a given point in time and generally does not involve itself with changes or occurrences during the proceeding year. It is these very occurrences that go to the heart of whether or not the brokerage firm has encountered difficulties in its operation and in its financial condition. The furnishing of the statement of financial condition alone necessarily creates the problem of the lack of adequate information to the public.

The very accountants who audit these brokerage firms have testified in our inquiry that in their opinion the statements of financial condition alone do not adequately

inform the customers of the financial health of the firm. In the opinion of some of the accountants interviewed, the balance sheet or statement of financial condition that is submitted to customers of brokerage houses purportedly for informational purposes is not able to convey even to an accountant, let alone to the lay person, the real financial condition of a brokerage house. Some of these accountants, when asked during the course of this inquiry why certain figures and financial information were not provided in the report to customers, replied that such information was not required by the rules. They admitted that such financial information and figures would be beneficial in the understanding of the financial health of the brokerage firm. It would appear to be a commonplace philosophy in the brokerage industry, apparently including the auditors, to provide the absolute minimum of information.

Most of the accountants interviewed agreed that profit and loss figures are a necessary accompaniment to balance sheets in order even to have a basis for a minimal understanding of the financial condition of the company reported upon. As a matter fact, these two financial statements are the backbone of the financial reporting of any company and is taken for granted in any other industry. There is no valid reason why this industry is excused from

such a fundamental part of its financial report. There is a great deal of resistance to the disclosure of profit and loss figures by Stock Exchange firms probably because of historical reasons.

For the most part, the brokers consider themselves to be private partnerships, whose internal affairs are for the eyes of the partners alone.

While this attitude might be justifiable and understandable with respect to those firms that do not handle customer accounts, it is not valid when applied to firms that have any fiduciary or custodial obligations with respect to customers' monies and securities. At this point they are no longer private clubs, but must bear the responsibility that they have assumed, and allow close scrutiny of their internal conditions. This close scrutiny is nothing more than the routine financial reporting requirements of other companies affected with the public interest.

Twelve of the clearing brokers refused to give any figures of profit or loss in answer to our questionnaire even though such refusal to answer such questions might invoke the sanctions of Article 23-A of the General Business Law. The refusal to furnish the Attorney General's

Office, an authorized regulatory agency, with profit and loss figures for the last three years aptly illustrates the stubborn attitude of some of these brokerage firms to abandon their private clublike attitude initiated under the buttonwood tree. So intent are these firms to avoid the revelation of pertinent information and to maintain the confidential aura of their internal affairs that in their answers to questionnaire, which is required to be submitted to the Exchange under the rules, the names of certain individuals such as subordinate lenders involved in the financial statements are coded. Only a select few at the New York Stock Exchange and the Securities and Exchange Commission are able to know who or what is involved.

Contrast the above hesitancy to reveal profit figures with the statements made by the New York Stock Exchange in a booklet entitled, "Understanding Financial Statements - 7 Keys to Value" and dated November 31, 1970 at page 2 the following statement is made:

> "The member firms of the New York Stock Exchange throughout the nation are always happy to furnish facts they have available and help you interpret financial information about companies in which you are interested."

While it does explicitly state that this offer

of help and anxiety to furnish facts is confined to those companies which are listed on the Stock Exchange for trading, it is difficult to see why such an offer of information should not include the financial details of the broker himself. While it is true that the customer is not making a direct investment in the brokers' business, it is clear that his degree of financial interest is at least as high as in a firm in which he plans to invest because in both cases he is putting his money or his property in a fiduciary capacity with some other person or entity.

In light of this, the following quotation on page 4 of the booklet is of considerable interest:

> "Since financial statements covering a single year are not by themselves especially meaningful, two successive statements are employed for the purpose of our hypothetical study. Most annual reports now include statements for both the current and the previous year, and in many instances summaries for 5 to 10 year periods are provided. By measuring one against the other, a pattern may emerge that can be helpful to the investor."

To continue with this primer on financial statements, the following constitutes an admirable admission to the investor:

"As professionals in the financial community

realized both the income account and
balance sheets must be carefully analyzed."

It is clear from these quotations that the New York Stock Exchange itself recognizes that comparative balance sheets and earnings statements (also known as profit and loss statements or income and expense statements) are basic reports for an investor to have in hand in learning something of the company upon which these statements report. Contrast this with the real life situation which currently exists in the security brokerage field wherein only the certified balance sheet is generally given.

It is apparent that the securities brokerage industry is way behind the times in supplying financial information that can begin to have real meaning for the individuals and institutions which do business with them.

Several accountants have also testified that the customers would be well served by being provided with the ratio of aggregate indebtedness to net capital. Under the rules of the New York Stock Exchange and the Securities and Exchange Act, the aggregate indebtedness cannot exceed more than 2,000% of the net capital.

The New York Stock Exchange has established an early warning level as regards the ratio of aggregate

indebtedness to net capital. It must be informed when the ratio of a firm exceeds 1,200%. Presumably, this is a significant level of concern for the New York Stock Exchange. It is recommended that the customers of the brokerage house be similarly informed. We have found, however, that the practice is to the contrary. The customers, with very few exceptions, are not informed of any crisis with respect to the ratio requirements. Generally, when the ratio is such that it suits the company to inform its customers, the ratio is given. For example, in the case of one broker for the years 1968 and 1969, the ratio exceeded 1,200% for significant periods of time. The reports to customers, of course, did not reveal any crisis situation. However, in 1970, when the ratio improved, the company very proudly proclaimed in its Statement of Financial Condition to its customers:

> "Our aggregate indebtedness to net capital ratio of 4.2 to 1 compares with the New York Stock Exchange standared of 20 to 1".

When the ratio was unsafe according to the New York Stock Exchange standard, the customers of this broker were notinformed. Some witnesses in our inquiry have given their opinion that the net capital ratio is usually not provided in statements to customers because it is a highly

technical and specialized calculation. They have also implied that these high technicalities are beyond the comprehension of the average customer and, therefore, rather than to confuse the customers, this information is usually not supplied.

Our survey has indicated, however, that unfavorable information as to this ratio is virtually never given when it could possibly be interpreted as being too high, or borderline, or bad, or unsafe, or unfavorable.

ILLUSTRATIVE CASES

An apt illustration of the failure of the investing public to be informed of the true financial health of the brokerage firm with which they are dealing is the case of Broker X. This company is an amalgamation of several securities houses which took place in the middle of 1970. Apparently, the firms that amalgamated were losing money badly during 1970 and the losses have increased rather than diminished up until the recent present. For the years 1968, 1969 and 1970, the auditors for Broker X reported to its <u>broker clients</u> material inadequacies in the accounting system, internal accounting control and procedures for safeguarding securities. For the years 1968, 1969 and 1970, the Statement of Financial Condition submitted to <u>customers</u> did not disclose these findings of the auditors to the customers. The Statement of Financial Condition had a "clean" accountant's opinion. As a matter of fact, the accountant's opinion states:

> "Our examination was made in accordance with generally accepted auditing standards and accordingly included a review of the accounting system, internal accounting control and procedures for safeguarding securities, and such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In our opinion, the

above statement presents fairly the financial position of * * * in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

While the customer was being told that the accountants had tested or reviewed for such categories, the conclusion that the tests revealed serious shortcomings as reported elsewhere to the firm were withheld from the customers.

We have found during the course of examining hundreds of certifications by the various auditors that typically they recite that they have reviewed the accounting system, internal accounting control and procedures for safeguarding securities. However, they virtually never state what conclusions they have reached as a result of such a review, neither as to adequacy or inadequacy. The customer, therefore, can easily be deceived into thinking that the independent auditors have given his broker a clean bill of health with respect to its accounting system, internal accounting control and procedures for safeguarding securities.

It is appalling to treat as confidential material, the shortcomings found by auditors in the internal operation of the brokerage firm. Under the rules, for example, S.E.C. 17a-5(b)(3),-- the auditors are permitted to make

a supplementary report in a separate binding whereupon such report is deemed to be confidential. In the instant case a number of inadequacies were found. It appears illogical to carefully report in the Statement of Financial Condition directed to the customers that a very important aspect of the activities of the broker has been professionally reviewed, and then fail to state any conclusion concerning such review. In the case of Broker X it becomes clear, from an examination of the confidential reports filed with the New York Stock Exchange and the Securities and Exchange Commission that certain material inadequacies were actually found in the accounting system, internal accounting control and procedures for safeguarding securities during the period under review. Among the inadequacies found were substantial securities counts differences with inadequate follow-ups and reserves; failure to reconcile bank statements on a current basis; inadequate processing of stock records; substantial amounts of customers with unsecured, partially secured or under-margin accounts; and deficient segregation instructions. Interestingly enough, these inadequacies were also reported in the audits for the years 1968 and 1969 and yet the steps taken, if any, to correct these deficiencies were not effective.

Further, in the case of Broker X the ratio of

aggregate indebtedness to net capital exceeded the warning level of the New York Stock Exchange throughout all of 1968, 1969 and 1970. The ratio was as high as 1,700% and 1,800% for many months during this period of time. While the customers of the company received statements of financial condition for dates within those periods, such statements in no way reflected to the customers the fact that the firm was reaching the 2,000% level with respect to its ratio.

Other instances have been found of companies which have proudly proclaimed their ratios in their reports to customers when it was to their advantage to do so and when the ratio was extremely small and thus highly favorable.

In the case of Broker X elaborate annual reports were also prepared for the years 1968 and 1969, ostensibly to keep their customers informed. In the annual report for 1969, the chief executive of the broker, in his message to clients, stated as follows:

> "Although, as a privately owned partnership, our firm is not required to publish an annual report, this is the fifth year that we have done so because we feel an obligation to our clients to keep them informed in appreciation of their entrusting us with their investment transactions."

The message goes on to discuss the problem of profitability in the securities industry and refers thereader to an operating loss for the year 1969 which appears on another page of the report in a five year comparative table in juxtaposition to the Statement of Financial Condition with a clean accountant's opinion on the next page could conceivably be interpreted by the reader as a certified Profit and Loss Statement. It should be emphasized that when questioned concerning the loss for 1969, which was shown as approximately 4.5 million in the annual report, officials of the firm produced I.B.M. documents which indicated a loss in excess of $11 million, a $7 million difference. The disparity in the figures was never adequately explained by the officials.

The annual report of 1969, contained such glib statements as:

> "With capital funds aggregating $60 million and total assets of $557 million, our financial position is strong".

At the same time that this annual report was issued by the company, its net capital ratio approximated 1,600% and within a few months exceeded 1,800% requiring major transfusions of capital by outside interests in order

to stay afloat. The loss for the year 1970 was astronomical, almost $34,000,000 before any possible tax recovery. Far from being told that the firm's financial position "continues characteristically strong", the customers of this firm should have been warned ofpossible impending disaster.

Similarly the 1968 annual report to its customers contained glowing comments as "...our profit for 1968 was the second best year in our history" and an optimistic description of technological developments in back office procedures, etc. It did not reveal to the customers in this report that according to their own auditors "substantial inadequacies" existed. According to testimony from a Senior Partner of this firm, an annual report similar to the ones described in 1968 and 1969 was not provided for 1970. Apparently, the firm no longer had the basis for such favorable reporting.

As an illustration of the breakdown in accounting and internal accounting control systems, the audited security differences for this firm for the years 1968, 1969 and 1970 are as follows:

	Long Value	Short Value
1968	$29,875,067	$ 5,383,676
1969	29,687,696	7,598,845
1970	10,083,671	19,948,150

As the years progressed, the internal control system regressed without any inkling of this being passed on to the customers in the form of reports. In a footnote which suddenly appears in the Statement of Financial Condition as of September 27, 1970, the accountants state:

> "Reserves in the amount of $10 million have been provided for possible losses in connection with security count differences, debit balances, and short security positions and $5.5 million for possible losses in dividend accounts and suspense accounts".

Despite this information the accountants still did not, in any direct way, indicate that their review of the accounting system, internal accounting control and procedures for safeguarding securities had revealed substantial inadequacies. A reader would be forced to deduce this for himself solely on the basis of the provisions for losses due to security count differences. This is hardly a candid way of reporting financial conditions.

To further illustrate the gap which exists between financial credibility as exemplified in the Statement of Financial Condition as contrasted to certain financial facts of life, total assets reported were in

excess of $485 million and capital funds were shown as in excess of $45 million. Superficially, this gives the appearance of a fairly substantial company with a certain amount of capital strength. Yet, as of that same date, other records show that this firm was hard put to keep its head above water by feverishly seeking out infusions of new capital. Under the circumstances, one might again be forced to conclude that the present arrangement for merely reporting financial condition as of a given date without using some of the special techniques which are supplied in the reports rendered to the New York Stock Exchange and to the Securities and Exchange Commission leaves the customer more in the dark than the present state of the art of accounting makes necessary.

Another case illustrative of the present method of reporting financial condition failure to adequately convey the true state of affairs of brokerage houses is the case of Broker Y. In its Statement of Financial Condition as of October 30, 1970 distributed to the public, the figures indicate that the firm has $56 million of assets as compared with its current liabilities of $47 million. The accountant's certificate states that the document fairly presents the financial position of the broker.

Upon closer examination of the financial details of this broker as reported in "Answers to Financial Questionnaire" as of October 30, 1970, based on a surprise examination as of that date, a number of significant details concerning the financial status of this broker discloses a different story as compared to the brief financial document offered to its customers.

The Statement of Financial Condition indicates among the current liabilities of the broker an item designated "Money borrowed on securities...$30,275,000". There were no further notes or remarks to indicate what securities were used as collateral or the total amount of such securities. When the accountant who prepared this report was queried concerning the failure to elaborate on this item as to its underlying components he pointed out that under generally accepted accounting principles of the brokerage industry the information as given was sufficient and that it was unnecessary to further particularize the collateral. It should be pointed out that the logical considerations for a body of knowledge designated as generally accepted accounting principles does not permit a separate body of accounting principles particular to a special industry where such principles would be in conflict.

Thus, if there are generally accepted accounting principles, there cannot be differing principles for particular economic segments of business. The failure to particularize the source of the collateral is especially significant in this case since the auditors revealed in the Answers to Questionnaire that $6,700,000 was "pledged in error (since corrected)". This part of the collateral set forth in the balance sheet was improperly used without revealing such improper use to the customers.

This broker, not unlike an overwhelming majority of brokers, in the regular course of its business, pledges fully paid-for securities of customers to banks as collateral for loans, although such hypothecation is forbidden by Section 339-e of the General Business Law of the State of New York.

The accountant in this particular case, as is not uncommon with other accountants, indicated in his Answer to Financial Questionnaire that this amount of securities was pledged "in error". When asked why he characterized this violation as being an "error", his response was that he had no reason to believe otherwise. His response was such, even though for the previous two years like amounts of $6 or $7 million worth of securities

were similarly pledged or loaned "in error". Although his report indicated "pledged in error (since corrected)", the auditor admitted that as of the date of submittal of his report he had no knowledge of the extent of additional securities "pledged in error" in the regular course of business. The accountant stated that the reason for such errors was due to the necessary time lag during which bulk segregation instructions could be carried out. He indicated, however, that he was not concerned with this amount of error since this particular broker had sufficient free securities to correct such error by substitution of collateral. He stated that if this were not true, the situation would become quite serious.

Irrespective of this, however, it is to be concluded that the custodial function of the segregation of fully paid for securities has been replaced by a financing function. The gross nature of this situation is revealed, for example, in the Answer to Financial Questionnaire of September 27, 1970 of another broker. There, the auditors reported "pledged in error" fully paid securities to be in excess of $42 million. In actuality, brokers have been using such fully paid-for securities to finance the operation of their firms.

Indeed, an officer of Broker Y has related to the New York Stock Exchange that the reason for certain failure adequately to segregate fully paid for securities as a result of bank's requiring higher priced securities as collateral for their loans to brokers. This admission reveals that the so-called pledges "in error" are really not errors, but are designed to satisfy the collateral requirements of banks. Where the accountant had hitherto believed there were "sufficient free securities" to substitute as collateral to correct so-called erroneous pledges of fully paid for securities to banks, the fact remains that many of the "sufficient free securities" were not acceptable to banks as collateral because they consisted of low price stocks, thus severely reducing the available free securities. The accountant for this firm also indicated that the only brokers that would not have such "pledges in error" of fully paid for securities would be those firms which have great financial strength and do not have to use customers' securities, whether entitled to or not, in order to borrow money from banks. The well capitalized firms need not even "in error" violate Section 339-e of the General Business Law of the State of New York.

It would appear, therefore, that the necessity

for using customers' fully paid for securities as collateral in bank loans or as loans to other brokers may be necessitated by the lack of ample funds to conduct a brokerage business. The temptation is always there to dig into the supply of securities on hand which should be held in segregation as customers' property.

To illustrate the complete lack of uniformity in reporting the amount of fully paid for securities not segregated used in violation of segregation requirements, listed below is a sampling of typical headings used by the "BIg 8" accounting firms in reporting answers to Question 6G of the New York Stock Exchange "Answers to Financial Questionnaire". These headings are by way of explanation on the part of the accountants as to the accountability for fully paid for securities not segregated. Whereas the accountant in the Broker Y situation used the terminology "pledged in error (since corrected)" the following terminologies lack even an inkling that any violation may have taken place: "bank loan collateral"; "bank loan"; "bank loan subsequently segregated"; "collateral to bank loan"; "pledged as security for bank loans"; "loan subsequently withdrawn"; "bank loan subsequently segregated"; "collateral to bank

loan (since corrected)"; "differences resulting from clerical errors, etc."; "lost certificates"; "pledged in error"; "security difference account"; and "security differences and suspense account".

The Statement of Financial Condition sent to the customers by Broker Y fails to fully apprise the customers of the true financial condition of the company. during the past three years this company was actually in excess of the 1,200% early warning level of the New York Stock Exchange with respect to its ratio of its aggregate indebtedness to net capital and the company suffered severe losses from operations during the last two years.

The case of Broker Y also illustrates the prevalent practice by independent auditors of brokerage firms, contrary to generally accepted accounting principles, to conceal deficits of the brokers in the capital section of the balance sheets submitted to the customers of such brokerage houses. In the case of Broker Y the Statement of Financial Condition dated October 30, 1970 merely indicated one figure as representing the "capital" of the firm. The customers of the firm, upon reading this balance sheet, were in no way informed that the capital

included an operating deficit for preceding periods. this information was available only upon an examination of Answers to Financial Questionnaire--Part I. The figures in the Customer's Statement of Financial Condition simply shows one figure of approximately $1.5 million in capital. While virtue is sometimes attributed to brevity and simplicity, it does not excuse the concealment of an accumulated deficit of some $3.5 million, which, if known to the customers of the firm, may have influenced their course of conduct with respect to this broker.

As indicated, this practice of concealment of deficit by the combining of all categories in the capital section into one figure prevails with respect to the financial statement of most corporate brokers, especially when there is a deficit to be hidden. We have been given the historical reason that such method of reporting capital derives from the fact that most brokers originally were in the partnership form of business. But such method of accounting has been carried over to the corporate form of business as well. The masking of the deficit by the combining of such figure in the capital section parallels the failure of

the brokers to provide profit and loss information, comparative balance sheets and statements of changes in equity to the public generally.

In total these practices aim at masking the true financial stature of brokerage firms.