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STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS

REPORT AND RECOMMENDATIONS

OF THE

SECURITIES AND EXCHANGE COMMISSION

(Pursuant to Section 11 (h) of the Securities Investor Protection Act of 1970)

DECEMBER 1971

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SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., December 28, 1971.

THE PRESIDENT OF THE SENATE.
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

GENTLEMEN: I have the honor of transmitting herewith the Study of Unsafe and Unsound Practices which the Securities and Exchange Commission was called upon to prepare for the Congress by Section 11(h) of the Securities Investor Protection Act of 1970.

This statute was enacted against a backdrop of the most prolonged and severe crisis in the securities industry in forty years. Widespread failures of broker-dealer firms and concern for the funds of their customers had followed a prolonged period of easy business. Rising brokerage income and rising security prices had produced a general euphoria. In this mood, expansion of sales effort and overhead had not been properly supported by more capital and stronger back office effort. A veritable explosion in trading volume clogged an inadequate machinery for the control and delivery of securities. Failures to deliver securities and to make payment ricocheted through the industry and firms lost control of their records and of the securities in their possession or charged to them. Operational conditions deteriorated so severely that securities markets were required to cease trading one day each week at one point, and later to limit daily trading hours. Those conditions should not be allowed to recur.

To insure against future breakdowns under the significantly increased volume of securities transactions which will be necessary if the nation's capital needs are to be met in the years ahead, a modernized, nationwide system for effecting securities transactions must be created. Clearance, settlement, depository and transfer functions form part of a continuous process. To ensure the prompt development of a national system, the Commission's present authority over clearance, settlement and recordkeeping should be extended to depository and transfer functions as will be developed later in this letter.

Reviewing the 1967–70 period, it would be easy to point out errors, omissions and failures. Firms and self-regulatory authorities were thrashing about in all directions fighting to avoid catastrophe. Time and time again they had to select the lesser evil. Decisions had to be made in a rapidly changing situation. The problem faced by those responsible can perhaps best be appreciated by going to Tolstoy's *War and Peace*. Of Kutuzov, the Russian commander facing Napoleon before Moscow, Tolstoy wrote:

"The commander-in-chief is always in the midst of a series of shifting events and so he never can at any moment consider the whole import of an event that is occurring. Moment by moment the event is imperceptibly shaping itself, and at every moment of this continuous, uninterrupted shaping of events the commander-in-chief is in the midst of a most complex play of intrigues, worries, contingencies, authorities, projects, counsels, threats and deceptions, and is continually obliged to reply to innumerable questions addressed to him, which constantly conflict with one another.

". . . [A] commander-in-chief, especially at a difficult moment, has always before him not one proposal but dozens simultaneously. And all these proposals, based on strategies and tactics, contradict one another. A commander-in-chief's business, it would seem, is simply to choose one of these projects. But even that he cannot do. Events and time do not wait.

"An order [to retreat] must be given to (the adjutant) at once, that instant. And the order to retreat carries us past the turn to the Kaluga road. And after the adjutant comes to commissary-general asking where the stores are to be taken and the chief of the hospitals asks where the wounded are to go, and a courier from Petersburg brings a letter from the sovereign which does not admit of the possibility of abandoning Moscow, and the commander-in-chief's rival, the man who is undermining him (and there are always not merely one but several such), presents a new project diametrically opposed to that of turning to the Kaluga road, and the commander-in-chief himself needs sleep and refreshment to maintain his energy, and a respectable general who has been overlooked in the distribution of rewards comes to complain, and the inhabitants in the district pray to be defended, and an officer sent to inspect the locality comes in and gives a report quite contrary to what was said by the officer previously sent . . ."

The unsafe and unsound practices

The purpose of this report is not to indulge in recriminations and second guessing but rather to erect safeguards for the future. We have studied the record and experiences of 1967–70 to define what went wrong and to identify the conditions and practices of the industry which permitted things to get out of control. The practices so identified are these:

1. Capital was inadequate and not sufficiently permanent or liquid.
2. Restrictions over the use of cash and securities held for customers were inadequate.
3. Early warning signals were inadequate to foretell financial and operational difficulties in a reliable and timely manner.
4. Branch offices, sales forces and advertising budgets were expanded beyond the capacity or the ability of the business and capital of many firms to support them.
5. Securities were not checked and counted frequently enough nor controlled tightly enough.
6. Insufficient talent and training effort was put into back offices.
7. Books and records were permitted to fall behind a mounting volume of transactions and bank statements were not reconciled frequently or soon enough.
8. New and expensive technologies were hastily brought to bear on the paperwork problem without adequate preparation, analysis of cost or mastery of technical requirements.

9. Records were put on computers without maintaining the old records for safety until the computer operation proved itself.

10. Short stock record differences were permitted to accumulate without research and a "buy in", thus putting firms at the risk of the market.

11. Long stock record differences were sold out to raise cash which also put firms at the risk of the market as to those securities ultimately claimed validly by customers.

12. "Fails" were permitted to remain outstanding, causing additional fails in subsequent transactions and resulting in shock waves of loss throughout the brokerage community.

13. Delivery, clearing and transfer facilities became hopelessly clogged as they proved unequal to the increased volume, and failures of all kinds accumulated.

14. As spelled out in the report of the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce entitled *Review of SEC Records of the Demise of Selected Broker-Dealers*, new firms with minimal capital and little managerial background or training were able to run up as much as half a million dollars in liabilities in a relatively few months and then collapse.

Some of these practices existed widely among the some 5000 brokerage firms making up the industry, others only here and there.

SUMMARY OF CORRECTIVE MEASURES ALREADY INSTITUTED AND PROPOSED

Brokerage firms, the self-regulatory agencies and the Commission have separately and together developed a series of new rules and practices designed to eliminate or moderate the unsafe and unsound practices which have been identified. In some instances these measures have represented as much improvement as it was felt could be taken in a single stride without setting up counterproductive reactions. For example, tightening a capital rule, can frighten capital away as well as achieve its intended purpose of locking capital into a firm's structure.

The major corrective measures taken and proposed by the industry and the Commission under existing legislation, including the 1970 SIPC legislation, are these:

1. Additional capital and more conservative operations have been required by reducing the maximum ratio of aggregate indebtedness to net capital for NYSE firms from 20 to 1 to 15 to 1.

2. Capital will in the future be made more permanent by requiring that neither subordinated debt nor equity may be withdrawn if it would bring the capital ratio above 12 to 1 for NYSE firms.

3. Capital has been made more liquid by increasing the required deductions (haircuts) on proprietary security positions, particularly regarding large security positions, of NYSE firms.

4. Additional permanent capital has been brought in since March 1970 through more than 20 registered public offerings by broker-dealers covering securities having an aggregate market value of approximately $300 million. Additional long-term capital is becoming available as banks satisfy themselves as to the security of term loans to brokerage firms.

5. Control over undue expansion and operational capability is provided by a requirement that expansion by an NYSE member firm may not be initiated when its net capital ratio exceeds 10 to 1 and that contraction must be initiated when such ratio reaches 12 to 1.

6. The Commission has attempted to ensure early warning of a firm's difficulty by the following steps:

(i) requiring immediate telegraphic notice to the Commission and all appropriate self-regulatory agencies of any net capital violation with a follow-up report of financial and operational condition;

(ii) requiring an immediate report of financial condition from broker-dealers ceasing to be a member in good standing of a national securities exchange;

(iii) requiring immediate telegraphic notice when a broker-dealer's books and records are not current, with a follow-up written report within 48 hours showing corrective steps taken; and

(iv) requiring monthly operational and financial reports from broker-dealers whose net capital ratio exceeds 12 to 1 or whose net capital is less than 120 percent of the minimum total net capital required.

7. Control over securities has been tightened by requiring broker-dealers to engage in a quarterly physical examination and count of all of the firm's securities and those of its customers.

8. Rules have been developed and published for comment to afford greater protection to customers' free credit balances and to securities left with brokers. The thrust of these rules is to restrict the use of customers' assets in the broker's business.

9. Under this proposed rule, bank statements would have to be reconciled within two weeks after receipt.

10. New rules are designed to secure greater control over cash and securities held by brokers by requiring the mandatory buy-in of customers' securities which have not been reduced to possession of control within designated periods of time.

11. Amendments to the NYSE net capital rule require the full charging of short stock record differences after 45 days.

12. A proposed amendment to Commission Rule 17a–5 would require that customers be furnished annually a report on net capital and income, a balance sheet, a source and application of funds statement, and other financial information.

13. A proposed amendment to Commission Rule 15c3–1 would increase the minimum capital requirements from $5,000 to $25,000. A net capital ratio of 8 to 1 for the first year of operation would be required in order to encourage conservative operation by new entrants.

14. New entrants would be required to disclose details relating to their personnel, facilities and financing in their application for registration as a broker-dealer, under a proposed amendment to Commission Rule 15b1–2.

15. The Commission has established an Office of Chief Examiner to intensify its oversight of the self-regulatory process and to make more frequent and intensive independent inspections of broker-dealers who are inspected by self-regulatory agencies, and to inspect annually all broker-dealers which are not members of a self-regulatory organization.

16. All of the self-regulatory agencies have expanded their staff to increase inspections of their members.

17. The self-regulatory organizations will require a comprehensive, uniform financial and operational report monthly in order to improve surveillance and management's ability to recognize operational problems.

18. The use of the CUSIP number to identify securities has been fostered by the Commission's requirement that it be used in certain official reports and by the Commission encouraging the self-regulatory organizations to make it mandatory on all certificates and a number of forms and documents, commencing in the Spring of 1972.

19. The securities industry working with several large banks, under the umbrella of the Banking and Securities Industries Committee, has made progress in immobilizing the stock certificate by establishing a central depository for securities held in street and institutional name.

20. The NASD is developing a facility for clearing and settling over-the-counter securities transactions.

21. The Commission is forming a special staff to provide guidance and leadership in developing existing and projected operational facilities into a modernized, nationwide system for clearing and settling transactions, keeping custody of securities and recording transfers of ownership.

Additional measures in the financial and operational areas are being considered by the Commission. In particular we will continue to review the form and substance of the net capital test with a view to arriving at a standard net capital rule applicable to all registered broker-dealers with appropriate exceptions, which rule could be augmented by the self-regulatory organizations to meet their special needs. Further, we will consider what steps can be taken to deal with the mysterious disappearance of securities, such as the establishment of a reporting and identification system for missing securities.

Corrective measures requiring legislative action

While we believe the corrective actions we have already taken and proposed represent significant improvements in the manner in which broker-dealers conduct their businesses, the Commission also believes that additional statutory authority is needed to prevent a recurrence of the problems described by our Study and to furnish needed protection for investors as well as to maintain a strong and viable securities industry. We recommend that the Congress authorize the Commission to perform additional and closer regulatory oversight in four critical areas, namely: (a) the processing of securities transactions; (b) the rule making authority of self-regulatory organizations; (c) the enforcement of the rules of the self-regulatory organizations; (d) the administration of disciplinary proceedings conducted by the self-regulatory organizations.

The Commission's concern and basis for requesting this additional statutory authority is summarized in the following paragraphs:

1. The processing of securities transactions

The securities industry's operational problems are evidence that there is need for increased regulation by the Federal government of the transaction handling process, particularly with a view to standardization, automation, and increased protection for industry participants and members of the investing public. Regulation of the process as a whole is clearly desirable, and the Commission is in the best position to furnish such regulation in that it now has jurisdiction over the broker-dealer community, investment companies, stock exchanges, securities associations, issuer companies (in certain respects), and subsidiaries of exchanges and securities associations which now perform clearance, settlement and depository tasks. However, certain tasks, such as the transfer and registration of transfer of certificates, are not directly within the Commission's regulatory jurisdiction and even the depository function would appear to be subject to direct regulation by the Commission only if performed by entities which are registered with it. Therefore, in order to ensure that the transaction handling process can be made to function efficiently as a whole, the Commission recommends that it be given authority over the qualifications, performance, business practices and rules of entities performing transfer and depository functions, but only to the extent that their performance of these specific functions is involved. The Commission, in seeking this authority, is not desirous of expanding its jurisdiction to conflict with that of Federal or state bank-regulatory agencies. Economic regulatory authority is not being sought. Rather, the Commission is merely desirous of having all necessary authority to oversee the development of a unified securities processing system and the establishment of the performance standards and access practices necessary for the development and proper functioning of such a system.

2. The rulemaking authority of self-regulatory organizations

The Commission's present authority over the rulemaking of the self-regulatory bodies is an illogical patchwork of provisions which falls short of giving the Commission authority to act promptly and effectively where a rule, or a proposed rule, is or might be injurious to the public interest. Specifically, the Commission has no power to prevent the adoption of a particular rule by an exchange, nor to abrogate it once it has been adopted. It does have the power to require alterations in exchange rules, but only insofar as the rules relate to certain enumerated (or "similar") matters, and only after following cumbersome procedures. With respect to NASD rules, the Commission has broad powers to block a rule from being put into effect and to abrogate an existing rule, but its power to alter or supplement rules is very limited.

The Commission believes that the public interest would be better served if it had plenary authority with respect to the rules of the self-regulatory bodies. An appropriate pattern would be that recently adopted in Sections 3(e) and 7(a) of the Securities Investor Protection Act of 1970. The specific authority sought would be that to approve or disapprove of any new rule proposal or any proposed amendment, supplement or repeal of an existing rule, as well as the authority to require rule amendments and supplements, and the authority to abrogate rules. Action pursuant to such authority should be preceded by approprite notice and afford an opportunity for hearing.

3. The enforcement of the rules of self-regulatory organizations

A limitation of the Commission's oversight power over the self-regulatory bodies is that it cannot directly enforce their rules against their members. The Commission's power to withdraw the registration of a stock exchange or of the NASD in the event that they do not enforce their rules is so extreme that it does not present a viable regulatory tool. This was recognized by the Commission as far back as 1941, when it recommended that it be given specific enforcement authority as an effective remedy against "dilatory and lax enforcement" by self-regulatory bodies of their own rules.

As was stated then, the Commission would not expect to resort to direct enforcement proceedings in ordinary situations, but only when a self-regulatory body permitted a member to escape disciplinary proceedings to the detriment of the public interest. Presumably, the grant of this additional authority to the Commission would not only allow Commission action where there was a breakdown in self-regulation, but would also promote action by the self-regulatory bodies in two respects: first, it would give them an added incentive to do the job themselves, lest the Commission be compelled to act; and second, it would strengthen their hand in dealing with their members.

4. The administration of disciplinary proceedings conducted by the self-regulatory organizations

At present, The Commission has no oversight authority over disciplinary proceedings conducted by a stock exchange, and its authority over NASD proceedings is limited in that penalties assessed by the NASD can only be affirmed, diminished or dismissed, but not increased. In order to assure that discipline is administered fairly to members, and that the penalties imposed take into account the public interest, it would be appropriate for the Commission to have the right to review all disciplinary proceedings of a self-regulatory body upon appeal or on the Commission's own motion, and that such right to review include the power to affirm, disaffirm or modify in any way deemed to be required in the public interest, the findings of and penalties imposed by the self-regulatory body. Although the Commission's experience with NASD disciplinary proceedings indicates that the review power will be used sparingly, its importance lies in making enforcement actions in general fully effective and at the same time strengthening freedom of expression and action by members within the self-regulatory bodies.

CONCLUSION

I should point out that our information shows the securities industry has significantly improved its operational performance during the year since enactment of the Securities Investor Protection Act. For one, fails to deliver of New York Stock Exhange member firms, which rose from some $850 million at the end of 1966 to $4.1 billion at the end of 1968, have now levelled off at about $1.0 billion at November 30, 1971, with an even lower figure predicted for this year-end. For another, complaints received from the public—of which the vast majority are attributable to back-office problems—have subsided from a monthly average of over 1,500 at the end of 1970 to around 500 at present.

In developing and evaluating protective measures, we have been mindful that we are dealing with a moving situation. Some forms of protection useful now may become unnecessary as others are developed. For example, the net capital rule is and has from the beginning been the primary protection against financial irresponsibility of brokers. When the proposed rules for segregating customers cash balances and establishing reserves for unsegregated securities have been fully implemented and have proven their ability to protect customers' funds, the net capital rule may become less important.

Major improvements, now clearly possible in the future but requiring time to implement, may make other forms of protection unnecessary. Thus, looking down the road a little further, the time will come when the execution of a trade will be electronically conveyed to a point where securities are transferred by electronic record with paper printout and payment is made by similar electronic means. At that point the clearance process and the segregation of customers' cash and securities may be unnecessary.

Furthermore, we recognize that some of the corrective measures enumerated herein represent burdens and costs to the industry. We have been and will continue to be sensitive to the desirability of minimizing adverse operational and financial impact. However, at this time, we believe that the increase in public confidence which will flow from measures taken to protect public funds far exceeds the burdens and costs of implementing such measures.

The ultimate objective in improving business practices in the securities industry is to serve and protect the investors of this country and the free world so that they will entrust their savings to the privately owned and operated sector of our economy. To merit that trust, the industry must assure investors that their savings put to work in the American capital markets are protected against structural weaknesses; that they have access to reliable and meaningful information about the performance of the companies in which they invest and that the markets are fair, honest and efficient in establishing the values of securities.

We believe that the measures already taken, those about to be taken, and those recommended in this report, will contribute to the achievement of those broad goals.

By direction of the Commission.

WILLIAM J. CASEY, *Chairman.*

PREFACE

Unlike most previous studies conducted by or on behalf of the Commission, this study pursuant to Section 11(h) of the Securities Investor Protection Act of 1970 was carried out exclusively by its regular staff. Subject to the over all responsibility of Irving M. Pollack, Director of the Division of Trading and Markets, the work of the Study was headed by Ezra Weiss, Chief Counsel of that Division, who was ably assisted by a group composed of (in alphabetical order), Peter Ambrosini, Charles Hartman, Charles Lerner, Morris N. Simkin, and Bruce I. Weinger. Special Counsel to the Chairman, Lee A. Pickard made a substantial contribution to the completion of the Study. Other staff members of the Division of Trading and Markets who assisted were Stanley Sporkin, Hurd Baruch and Albert D. Sturtevant. Mention should be made of the contribution of the following members of the Office of Policy Research: Dr. Gene L. Finn, Hajo Lamprecht, Robert H. Menke, Le Manh Tri and Terry M. Chuppe. Chapter II of the Study is largely based upon the report of OPR entitled "The Financial Condition of Broker-Dealers: A Question of the Adequacy of Capital and Regulatory Safeguards." Although wholehearted cooperation was received from the entire clerical and secretarial staff, special mention must be made of Mary Jo Horn, Patricia Turner and Florence W. Culbreth of the Division of Trading and Markets, and Frances Sienkiewicz of the Chairman's Office, for their unflagging efforts and the cheerful manner with which they performed their most arduous tasks.

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CHAPTER I—INTRODUCTION, SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

INTRODUCTION

Concerned that there might be a recurrence of events which gave rise to the Securities Investor Protection Act of 1970 (the "SIPC Act"), Congress directed the Commission to compile a list of unsafe and unsound practices by broker-dealers in conducting their business and to report to the Congress the corrective steps being taken under existing law, and to submit recommendations on additional legislation which might be needed, to eliminate those unsafe and unsound practices.[1]

The statute of which this directive is a part was adopted against a backdrop of liquidations, mergers and the demise of a substantial number of large and small broker-dealer firms in 1969–70. Coupled with the elimination of these broker-dealer firms was the threat of loss of public confidence in the securities markets. The events which led up to these disturbing developments are discussed and documented in this study. They afford reasonable explanations as to what happened to a theretofore reasonably solvent industry. However, in and of themselves, these events furnish no insights as to their underlying causes, namely, the basic structural weaknesses of an industry which could not withstand the stresses and strains placed upon it by events of virtual hurricane force. The events themselves could well recur. It has been and continues to be the plain task of all segments of the nation concerned with public protection in this area to diagnose these structural weaknesses and to effectuate a cure.

The defects fall into several broad categories. First and foremost is the inadequacy and impermanence of capital, and, in some cases, the injudicious employment of such capital as does exist. Secondly, the securities industry has historically placed emphasis on sales and trading activities. The function of the operations personnel and of the back office traditionally has received little recognition; rather they have been looked upon as a necessary burden and rarely as a profit center or vital element of the business. During the critical period in question there was a dearth of individuals of managerial caliber and a lack of systems, procedures, equipment and qualified nonsales personnel for the maintenance of accurate records on a current basis. There was an absence of control of securities traffic to provide assurance for prompt deliveries of securities and remittances of payments. These circumstances resulted in a virtual breakdown in the control over the pos-

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[1] Section 11(h) of the SIPC Act provides as follows:

"SEC. 11. MISCELLANEOUS PROVISIONS.

* * * * *

"(h) SEC Study of Unsafe or Unsound Practices.—Not later than twelve months after the date of enactment of this Act, the Commission shall compile a list of unsafe or unsound practices by members of SIPC in conducting their business and report to the Congress (1) the steps being taken under the authority of existing law to eliminate those practices and (2) recommendations concerning additional legislation which may be needed to eliminate those unsafe or unsound practices."

session, custody, location and delivery of securities, and in the payment of money obligations to customers, all of which exposed customers to the risk of the loss of their cash and securities. The industry and to an extent the self-regulatory bodies themselves, had not implemented or planned broad based solutions to the settlement process and the related flow of paper. Another important infirmity lay in the regulatory structure itself—in the heavy emphasis on disclosure requirements and fraud prevention—and the inability of the self-regulatory organization to respond to the crisis with meaningful corrective measures. The absence of an effective early warning system caused belated action and less effective actions when the full impact of the crisis was finally ascertained; and still another problem related to the many insolvencies of relatively small concerns whose principals were found wanting in experience upon which to conduct a successful operation, but who were nevertheless able to engage in the business on a virtual shoestring because of the ease-of-entry requirements.

The need for this retrospection is quite plain if the factors which contributed to the unfortunate 1967–70 results are to be identified and corrected. If continued, they may produce an unwarranted drain on the resources of SIPC or leave untouched the exposure of public investors to the risk of loss of funds and securities not covered by SIPC.[2] Investors' confidence in the United States securities markets could again be threatened. Consistent with what we understand is our mandate from Congress, the Commission has placed the central focus of this study upon those practices and conditions which have jeopardized the integrity of funds and securities left by customers in the possession of broker-dealers—practices which led to the crisis which prompted Congress to enact the SIPC Act. Accordingly, this report directs itself to methods of achieving permanent improvement of this vital sector of the nation's economy, the securities markets.

The matters discussed in this summary are examined in detail in subsequent chapters of this report. A brief summary of the salient topics, however, is included in this chapter, immediately following this section. Following the summary is a description of specific action taken by the Commission under the authority of existing law, particularly the recently enacted SIPC legislation, to strengthen the securities industry and protect customers' funds and securities on deposit with broker-dealers. Conclusions and recommendation for additional legislation need to eliminate certain unsafe and unsound practices of broker-dealers also accompany this summary.

NATURE OF REPORT

The material for this report consists principally of records of the 1967–70 events as reflected in the files of the Commission and the self-regulatory organizations,[3] including the financial reports filed with the self-regulatory organizations and reports relating to individual firms which provide illustrative material for the problems under discussion. Additionally, reference is made to individual case studies of

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[2] SIPC covers only $20,000 of cash per account and a maximum of $50,000 of loss of cash and securities combined in any one account. SIPC Act, sec. 6(f).

[3] The term "self regulatory organizations" refers to national securities exchanges registered as such with the Commission under section 6 of the Securities Exchange Act of 1934, and the National Association of Securities Dealers, Inc. (NASD), the only national securities association registered under section 15A of that act.

individual firms which exemplify the surveillance and enforcement problems of the self regulatory organizations. The report utilizes industry surveys and studies by management consultant companies and other responsible persons, including comprehensive and incisive analyses of the industry sponsored by Lybrand, Ross Bros. and Montgomery, Ernst & Ernst, the Rand Corporation, Wright Associates, North American Rockwell Information Systems Company, Arthur D. Little Inc., United States Trust Company, American Bankers Association, and the Banking and Securities Industry Committee, among others.

SUMMARY

1. *Composition of the 1968–70 reverses*

A. The 1967 paperwork crisis

In reviewing growth trends in the volume of securities transactions up to 1965, the New York Stock Exchange ("NYSE") in a report projected trading volume of the NYSE over the succeeding 10 years (namely, by 1975) of from 9 to 11 million shares a day.[4] However, by 1967, 15-million-share days were not uncommon; and even 20- and 30-million share days were experienced.[5] Thus, for the first quarter of 1967, the reported volume was about 14 percent above the previous record total for any three-month period. Moreover, the total 1967 New York Stock Exchange volume reached the staggering record of 2.53 billion shares, an increase of fully 33⅓ percent over the 1966 volume.[6] The industry was unprepared for this veritable explosion in trading volume. With some exceptions, the financial community found itself without appropriate systems, procedures, equipment, or qualified personnel for handling its business. Further, little could be done to implement the necessary solutions on a timely basis. The problems demanded broad solutions, and no one firm could tackle them in isolation. The aftermath was virtual chaos experienced by a substantial number of firms.

Apart from the inability of broker-dealers to keep their records current, the number of errors in the handling and recording of transactions multiplied. The back offices of many a broker-dealer resembled a trackless forest. Since the broker-dealer industry is a highly interdependent community, the problems of the less efficient firms had a rippling effect on the entire broker-dealer community; and interdealer clearing systems, as well as the transfer facilities of banks, were similarly taxed beyond their capacities. The entire machinery for the delivery and transfer of securities and the concomitant remittance of funds became clogged. Even those broker-dealers who attempted belatedly to stem the tide by computerizing their operations or augmenting their back office personnel could not keep pace with the vol-

[4] This forecast is contained in a NYSE document entitled, "The Exchange Community in 1975—A Report On Its Potential—Problems and Prospects—and Economic Study By The New York Stock Exchange, December 1965." A copy of this report is found at pp. 277 *et. seq.* of Hearings on the Study of the Securities Industry, pt. 1, by the House Subcommittee on Commerce and Finance (1971) (hereinafter referred to as "1971 House Subcommittee hearings").

[5] Congressional Record, Dec. 1, 1970, p. H10923.

[6] NYSE statement—"Crisis in the Securities Industry," 1971 House Subcommittee hearings, p 15. Volume on all exchanges rose 159 percent between 1964 and 1968. See statement of former Chairman Budge of the SEC before the Joint Economic Committee of the U.S. Congress, July 10, 1970.

ume; in fact, they were caught on a worse treadmill in that, by the time they were able to research their errors of a given date, they were confronted with a greater number of errors to contend with. The expensive computerized hardware which was thrown into the breach malfunctioned; and, since parallel manual records were often not maintained during a reasonable trial period, the use of the computer increased the already existing confusion. Moreover, the employment of newly recruited and untrained or inadequately trained individuals who were put to work in the back offices resulted in a further increase in the number of errors. The combination of all of these factors culminated in such a critical predicament for some firms that they not only lost control of their records, but experienced a new phenomenon—the loss of control over the securities which were or were supposed to be in their possession for delivery, custody or safekeeping. The efforts by the Commission and the self regulatory organizations to build a dike against this torrent proved of little avail.[7]

Even though the acuteness of the industry's problems was somewhat alleviated by an abrupt market reversal and the accompanying reduction in trading in the 1969–1970 period, the paper work problems continue to persist.[8] The system and procedures necessary to meet current and prospective trading volume have yet to be introduced on an industry wide basis.[9]

B. The 1969–70 market downturn

The advent of the market decline in late 1969 marked the beginning of extensive shrinkages in market values.[10] The diminution in the values of securities in firm and proprietary accounts of broker-dealers and the concurrent sharp drop in commission business proved too much for virtually all but the most substantial and well managed firms.[11] Trust funds which the exchanges had accumulated with the view of protecting public customers dwindled to the point of exhaustion.[12] It was in that context that the SIPC legislation was enacted by Congress. A detailed discussion of the 1967–1970 events is contained in Appendix A of this report.

C. Capital structure weaknesses

If the capital of an enterprise is viewed as the resources firmly imbedded in its financial structure, it may be said that there is a virtual lack of "capital" in the securities industry. As will be seen in later parts of this report, the greater portion of the resources available in the industry for the carying on of its business is contributed by customers in the form of cash balances left with their broker-dealers; and these are largely subject to withdrawal on demand. A substantial portion of the remainder consists of short term borrowings, and of contributions by partners or other principals of the enterprise on terms

[7] This report will detail the steps taken by the Commission and the self-regulatory organizations for correcting these inadequacies, such as more frequent surveillance, disciplinary proceedings, attempts to clear up deficiencies in operations, and to shore up firms in delicate financial conditions by liquidation, through mergers and the application of emergency trust funds. See appendix A.

[8] See staff study for the special subcommittee on investigation of the House Committee on Interstate and Foreign Commerce on a "Review of SEC Records of the Demise of Selected Broker-Dealers," subcommittee print, 92 Cong., first sess. (1971), p. 5 (hereinafter called "Staff Study").

[9] A more detailed discussion of this entire subject is found in ch. VIII of this report.

[10] 1971 House Subcommittee hearings, p. 20.

[11] H.R. Rept. 91–613, 91st Cong., 2d. Sess. (1970), p. 3.

[12] Ibid.

which most frequently provide for an untrammeled right of withdrawal.

The unfortunate use of the term "net capital" in the financial responsibility rules of the Commission and the various exchanges has resulted in a semantic confusion which too frequently has led to the mistaken belief that a broker-dealer's net capital is the equivalent of or has some relationship to the concept of "capital", as that term is commonly understood. "Net Capital" applies only to a hard core residue of net liquid assets designed to enable a broker-dealer to meet all rightful current demands of customers for their funds and securities.[13] As provided for in Rule 15c3-1 under the Securities Exchange Act of 1934,[14] the net capital of a broker-dealer is arrived at by the use of several stages of computations based on his assets and liabilities.

The computation begins with all of the assets reflected on the books and records of the broker-dealer. From this, all of the book liabilities are deducted, leaving a difference which the rule designates as "net worth". In turn, net worth is subjected to a number of adjustments principally designed to leave a residual dollar amount representing the current value of only those assets of the broker-dealer which are of high and demonstrable liquidity. For example, there is deducted from net worth all of the assets which cannot readily be converted into cash, such as furniture and fixtures, exchange memberships, securities not having a ready market, and the like. This is designed to leave a remainder consisting of virtually only cash and marketable securities; and even the portion attributable to marketable securities is reduced by specified percentages of their value which take into account the reality of market fluctuations. There are still other deductions and some possible additions of the residual amount (such as the proceeds of specified types of subordinated loans), until what remains is accorded the designation of "net capital". The net capital is then compared to another element in the net capital requirements designated as, "aggregate indebtedness". To begin with, aggregate indebtedness is composed principally of the same liabilities reflected on the books and records as are used in computing net worth. To those liabilities are added certain other obligations; and specified liabilities which are collateralized by specified kinds of assets are deducted to reduce that sum. With other adjustments, including the elimination of specified types of subordinated loans, a net figure for aggregate indebtedness is determined. Under the net capital rules, the dollar amount of "aggregate indebtedness" may not exceed a specified percentage of the dollar amount of net capital.[15] As already noted, the purpose of net capital requirements is to have the broker-dealer maintain a highly liquid position in order to meet all of his current obligations.[16]

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[13] Budge, "Broker-Dealer Financial Responsibility Requirements," 7 Idaho L. Rev., Fall, 1970 151, 158; *Guy D. Marionette*, 11 S.E.C. 967, 970–71 (1942).

[14] In this report the Securities Exchange Act of 1934 will be referred to as the "Exchange Act"; and the Securities Act of 1933 will be referred to as the "Securities Act."

[15] This ratio has varied from time. Currently, the Commission requires a maximum ratio of 2,000 percent, the same ratio which the NYSE applied for many years until the recent amendment of its rules specifying a maximum ratio of 1,500 percent.

[16] Conceivably, a broker-dealer having net capital less than the minimum required by applicable rules might meet his current obligations. Nevertheless, the stringency of the requirement is designed to provide customers with an extra cushion. Budge, *op. cit., supra*, n. 13. Should a broker-dealer continue to engage in business when he is unable to meet his current obligations, or when his liabilities exceed his assets, he would be violating applicable antifraud provisions of the Federal securities laws. That is, *SEC v. C. H. Abraham & Co., Inc.*, 186 F. Supp. 119 (S.D.N.Y. 1960); *M. Posey Associates, Ltd.*, Exchange Act release 6947 (Nov. 21, 1962) p. 1; *State Securities Corp.*, Exchange Act Rel. 7120 (Aug. 20, (1963); *Earl L. Robbins*, 39 S.E.C. 847, 849, (1960); *John D. Ferris*, 39 S.E.C. 116, 119 (1959); *Gill-Harkness & Co.*, 38 S.E.C. 646, 650–52 (1958).

As seen, whatever the merits may be of net capital requirements, they bear no relationship to the concept of capital as consisting of either long term funded debt or equity investment imbedded in the business for the life of the enterprise.

The explanation for the absence of long term funded debt in the capital structure and for the relatively minimal investment of equity by the managerial element of the securities industry lies in the unique characteristics of the broker-dealer activity and the history in which this business had developed. First, until the recent enactment of the SIPC legislation, there was the apparent right of the broker-dealer to utilize without restrain credit balances of customers.[17] Secondly, there is the ability of the broker-dealer to replenish his cash supply by the rehypothecation and the lending of securities of customers on which he extends or maintains margin credit.[18] Additionally, apart from occasional insolvencies resulting from gross mismanagement and flagrant fraudulent conduct, and with the exception of the extinguishment of some small nonexchange member firms with minimal public impact, the broker-dealer community suffered few insolvencies in the period following World War II; [19] and this climate prevailed until the industry found itself in the 1969–1970 predicament. Added to that, is the fact that the broker-dealer business is a cash business the assets of which are principally marketable securities and cash, as distinguished from relatively little fixed assets. Moreover, as the result of two isolated adverse experiences in the late 1950's and early 1960's of exchange member firms, the exchange communities established "trust funds" for use in a customer assistance programs.

The relatively successful use of the net capital concept as a tool of financial responsibility prior to the 1969–70 period coupled with the existence of significant "trust funds" administered by the exchanges which had proved adequate to cover customer losses to that point, left the industry and the self regulatory organizations with a complacent attitude respecting capital structure.

However well suited trust funds may have been to take care of isolated situations, they rapidly evaporated in the face of the industry wide difficulties.[20] Thus, had the SIPC Act not been adopted, the approximately $140 million which the New York Stock Exchange community has expended and authorized through its trust fund for the ultimate protection of customers [21] would have failed in its basic objective of maintaining public confidence in the securities markets.

In recognition of the fact that the form of financing which had prevailed prior to 1969 had become antiquated in the face of subsequent events and of the prospects for future trading volume, the

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[17] These include, among other things, "free credit" balances representing sums which customers have the absolute right to remittance upon demand as well as other funds of customers such as funds paid by customers for securities required by applicable margin regulations but which the customer has not received because his broker has, in turn, not received the security which is the subject of the transaction from the broker on the other side. Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Doc. No. 95, 88th Cong., first Sess. (1963) pt. 1 pp. 393–398 (hereinafter called "Special Study").

[18] Under the SIPC legislation, the Commission recently released for public comment (Exchange Act Release No. 9388) proposed rules which, upon adoption, will significantly restrict the use of customer funds and securities by broker-dealers. An extensive discussion of these rules may be found in ch. IV hereof.

[19] Special Study pt. I, p. 401.

[20] H.R. Rept. 91–1613, 91st Cong., 2d Sess. (1970) p. 3.

[21] 1971 House Subcommittee hearings, pt. 1, p. 28.

New York Stock Exchange adopted a rule permitting public stock ownership of its member corporations.[22] In addition to the foregoing measures, the NYSE, as an interim step, has substantially revamped its net capital rules; and other exchanges, such as the American Stock Exchange ("Amex") have followed suit.[23] The revisions of that Exchange's net capital rules are designed to slow down the possibility of a precipitate repayment of subordinated loans or withdrawals of partners' contributions by requiring six months' advance notice, and of precluding any such repayment, if the effect of such repayment would result in impairing or diminishing the firm's net capital beyond a specified point.[24]

The NASD has been conferring with the staff of the Commission on proposed rules under consideration by that body also, which would be designed to maintain the integrity of the net capital of its members.[25]

Any discussion of the subject of "net capital" and "capital" must take into account the amendment of section 15(c)(3) of the Exchange Act by Section 7(d) of the SIPC Act broadening and specifying with particularity the powers of the Commission on the subjects of reserves for customer credit balances and of the segregation of customers' securities. As noted above the Commission recently acted pursuant to this authority with proposed rules which will seriously restrict the use of customers' funds and securities in the business of a broker-dealer. Proper reserves and adequate custodial requirements and procedures should, by themselves, take over the liquidity objective of net capital requirements in large part. It is contemplated that, with operational experience, the rules regarding customer funds and securities [26] will eventually supplement and then eliminate the complex substructure of the net capital requirements and, with that, the corresponding intricacies of interpretation.

In addition to the inadequacies and impermanence of broker-dealer capital, among the several contributing factors to the 1969–70 downspin was the undue concentration of the resources of certain broker-dealer in securities whose values shrunk drastically in that period. Details on this subject will also be developed later in this report.[27]

D. Inadequacies of management

Assuming that the 1967–1970 events could not have been reasonably anticipated, nevertheless, the manner in which the industry reacted exposed another major weakness of the broker-dealer community—

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[22] Amendments to NYSE Constitution, art. I sec. 3(h) and art. IX secs. 9 and 11, Mar. 26, 1970. Pending proposals for rules on the subject which are still under consideration, the NASD withdrew its then existing flat prohibition against "self-underwriting", and, in lieu thereof has judged the distribution arrangements on a case-by-case basis. To date, several prominent NYSE member firms have completed or made preparations for public offerings of their common stock. These include such firms as Merrill, Lynch, Pierce, Fenner & Smith, Inc. (File No. 2–40156), Bache & Co., Inc. (File No. 2–41299), Piper, Jaffray & Hopwood, Inc. (File No, 2–40320). A. G. Edwards & Sons, Inc. (File No. 2–41309), CBWL-Hayden, Stone, Inc. (File No. 2–41001), and others.

[23] Amex Const. art. I, secs. 3(e), (g) and (h), and art. IV secs. 1(b) and (k).

[24] There are still some factors in the NYSE net capital rules which appear to fall short of the basic net capital objective of ready resources to meet current obligations. See, statement of Irving M. Pollack for the 1971 House Subcommittee hearings dated Sept. 3, 1971. The highlights of the NYSE net capital rule revisions are noted at pp. 28–9 of pt. 1 of the House Subcommittee hearings.

[25] See 1971 House Subcommittee hearings, pt. 1, p. 41.

[26] The Commissions proposed rules on these subjects are embodied in Exchange Act release No. 9388, Nov. 8, 1971.

[27] See ch. II, "Nature and Use of Broker-Dealer Capital" at pp. 70–72 *infra*.

the scarcity of individuals of managerial ability and talent. The general dearth of "black office" talent within the securities industry is said to be attributable to the historical orientation and concentration on sales promotions and trading profits. The results were vast discrepancies in securities records, the misuse, in some cases, of the funds and securities of customers, and even, in other cases, a degree of loss of control of securities which invited the theft of securities in massive quantities.[28]

E. Concentration on sales

The Special Study of Securities Markets undertaken by the Commission in 1962 and 1963 pointed out that managerial personnel in the securities industry, whether at the branch or home office supervisory level, have traditionally been selected, not on the basis of executive or administrative competence, but rather on the successes of individuals in sales.[29] It was manifested by the almost instinctive reaction of the financial community to the 1967 volume upsurge of opening and acquiring many additional sales outlets. Branch offices mushroomed and headquarters offices were rapidly expanded; and the industry lavished substantial resources on furnishings and other facilities for the expansion of sales. In this way, many broker-dealers saddled themselves with high fixed costs of a long term nature resulting from the leasing and equipping of the added sales space.[30] All of these activities displayed, as to those who engaged in them, a lack of sensitivity to the fluctuating nature of the securities market and the corresponding instability of customer interest in trading volume.

F. Excessive trading

There existed alongside the headlong sales drive a strong trading propensity. Our examination into the subject reveals that significant funds, in excess of the contributions of partners and subordinated lenders, were devoted to firm proprietary securities.[31] From our inquiry it was learned that (a) an undue portion of the assets of the industry is invested in securities and (b) the extent of this concentration is accounted for in part by the use of substantial sums attributable to customers free credit and other credit balances. That this rendered a broker-dealer vulnerable to the kind of market downturn as occurred in the 1969–70 periods has already been mentioned and will be further elaborated.[32] In brief, this combination of circumstances contributed to the collapse of many houses, and with them, the adverse experiences of customers.

G. The condition of books and records

Coupled with the enormous trading volume for firm accounts, the 1967–1968 heavy volume, itself generated by increased public interest and exacerbated by the number of new sales outlets, increasingly taxed the then existing, virtually static, facilities for processing the accompanying myriad of transactions. The initial impact of all of this was

[28] See ch. V, *infra*, on "Stolen Securities."
[29] Special study pt. 1, pp. 133–138.
[30] See ch. III, "Management and Operation Deficiencies," *infra*, at p. 95. See also July 19, 1970 statement of Hamer H. Budge, chairman of the Securities and Exchange Commission, before the Joint Economic Committee of the United States at p. 7.
[31] See ch. II *infra*, Table 1 at p. 51.
[32] Idem at pp. 70–72.

on the maintenance of broker-dealer books and records. For many firms, it became utterly impossible to keep books and records apace with the mounting speed and volume of transactions.

The response of some of the larger firms when they recognized the true conditions is of interest. Some were confident that the expenditure of money would alleviate the situation, and they began all too late to pour large sums into computer hardware without much awareness of the particular capabilities of the hardware selected or its compatibility with either their own existing equipment or with that of others where interfacing was essential for workability. Skilled personnel was not obtainable, and parallel operations with existing facilities were not in some cases maintained during a reasonable break-in period. Concurrently with the acquisition of the computer hardware, the industry began hiring people for the "back office" in a hurried and disorderly fashion. Initially, since not enough seasoned back office hands were available in the industry to meet the processing requirements of the rising volume, an atmosphere of pirating came into vogue. As this did not serve to increase the industry's capacity to any extent, the futility of this approach shortly became evident; and it was followed by the random hiring of untrained people, some of whom, it turned out, had unsavory backgrounds.[33] The net effect of all this was to turn the books and records of many broker-dealers into a veritable shambles. Since the books and records of a broker-dealer represent the cornerstone of his operations, all elements in the processing of transactions collapsed with them. Deliveries and transfers of securities became inexorably mired. Apart from the loss of the ability of broker-dealers to meet their accountabilities for cash and securities to customers, their obligations for the delivery and payment of securities as among themselves (the "street side") soared to the point that "fails to deliver" and "fails to receive" reached a total beyond all previous experience.

In December 1968, "fails to deliver" of New York Stock Exchange member firms amounted to $4 billion.[34] The greater the duration of a "fail to deliver",[35] the more the "failing" broker is exposed to the risks of possible financial difficulties of the broker-dealer to whom he is obligated to make delivery. Moreover, in order to fulfill his delivery obligations, he may ultimately be forced to procure the security at a price in the open market higher than the contract price.[36] The backing up of transfers and deliveries at the broker-dealer level was accompanied by clogged transfer facilities of transfer agents (usually banks), and this further dwindled the supply of securities for delivery to customers who had fully paid for them as required by applicable Federal Reserve requirements.[37] There followed the worst securities snarl ever experienced

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[33] See ch. III *infra* at p. 120 and ch V. at pp. 149–150.

[34] 1971 House Subcommittee hearings pt. 1, at p. 17.

[35] A "fail to deliver" represents the obligation of a broker-dealer to deliver securities to another broker-dealer beyond the conventional 5 business days settlement period. A "fail to receive", the converse of a "fail to deliver", represents the obligation of a broker-dealer to pay money to another broker-dealer against the receipt of a security after the settlement period has passed.

[36] It was in this context that the Commission and the exchanges adopted amendments to their respective net capital computation requirements providing for adjustments to net worth by the deduction from net worth of specified percentages of the contract prices of fail to deliver items on a broker-dealer's books and records which are in existence beyond specified periods of time. See Exchange Act release No. 8508, Jan. 30, 1969.

[37] With minor exceptions, under sec. 4(c)(1)(i) and 4(c)(2) of Regulation T, 12 CFR 220.4(c)(1)(i) and 4(c)(2), a broker-dealer must receive payment for a security purchased by a customer in a special cash account promptly or liquidate or cancel the transaction within 7 business days.

by the broker-dealer industry. The inability of brokers and dealers to locate securities belonging to customers resulted in significant "short stock record differences." Many broker-dealers found substantial quantities of securities in their possession without knowing to whom they belonged. These are "long" stock record differences. Short stock record differences of any duration represent in essence the equivalent of money liabilities to customers which should be marked to the market values of the missing securities; and they represent a corresponding hazard to the financial position of a broker-dealer.

As the Commission applies its net capital rules, the amounts of a broker-dealer's short stock record differences are treated as liabilities in the computation of net capital.[38] Of course, long stock record differences represent securities belonging to others; hence they may not be treated as assets of a broker-dealer carrying such differences.[39]

Caught in those circumstances, harried managements of broker-dealers in many cases tolerated the improper use of the fully paid and excess margin securities of customers which should have remained in their custody. This was not in accordance with applicable anti-fraud principles and the specific rules of the self regulatory organizations.[40] In disregard of those standards and of applicable hypothecation rules,[41] a number of troubled firms improperly took desperate measures to turn fully paid and excess margin securities of their customers into cash by loaning them against cash deposits or by using them as collateral for borrowings. Finally, the chaotic state of affairs furnished a suitable climate for the theft of securities by a number of the back office personnel who had been hired and had entered the back offices under the wholesale hiring program.

Numerous suggestions of management consultant groups, interested organizations and the industry itself may be found in this report for the improvement of back office procedures and the avoidance of the problems directly attributable to inadequacy of management in this vital administrative area. In addition to the emphasis on proper training programs for persons of management caliber and for back office personnel, all of these commentators emphasize the necessity for intelligent computerization of back office operations. Beyond that, the recommendations include the immobilization and possible elimination of the certificate, or the creation of a machine readable certificate, the increased use of central depository systems and the enlargement of the net-by-net clearing system under which the clearing corporation assumes the obligation of both the selling broker and the buying broker, as well as the greater cooperation, expansion, and decentralization of bank transfer facilities.

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[38] One of the points of difference during the period under discussion between the application by the Commission of its net capital rule (rule 15c3-1 under the Exchange Act) and the application by the New York Stock Exchange of its rule was that, unlike the Commission, the exchange treated as a liability only a modest reserve established by the member of such member's short stock record differences. See, *infra,* the discussions on this subject at ch VI at pp. 158–159.

[39] For some time during the period under discussion, the New York Stock Exchange tolerated the practice of "netting" by its member firms of their long and short security differences. It was pointed out to the exchange that this lacked any foundation, and the exchange discontinued that practice.

[40] NYSE rule 402(a)(b) and (c); NASD Rules of Fair Practice, secs. 19(a), (b), and (c). It is a violation of applicable antifraud provisions for a broker-dealer to hypothecate or otherwise convert fully paid securities of customers. E. Weiss, "Registration and Regulation of Broker-Dealers," BNA, (1965), p. 181 and cases there cited.

[41] Exchange Act rules 8c-1 and 15c2-1.

2. The regulatory policy

As outlined in the preceding portions of this summary, the problems of the securities industry consisted of management, operational, and capitalization deficiencies. However, there remains the nagging question as to how well the regulatory authorities carried out their responsibilities in the 1967–70 climate.

The principal statutes [42] under which the general regulation of the securities markets is conducted place heavy emphasis upon full and fair disclosure and the prevention of fraud.[43] With regard to those few provisions found in these acts which do call for the exercise of governmental judgment in the economic sphere, Congress has limited the scope of the Commission. This is illustrated by the provisions of Section 7 of the Exchange Act respecting rules governing the extending, maintaining, and arranging for credit on securities. These functions have been placed exclusively with the Board of Governors of the Federal Reserve System. As the legislative history demonstrates, the motivation of Congress in that respect was that those matters were in the realm of economics and their regulation should properly be lodged with an agency having the staff, facilities, and requisite knowledge for acting in that field.[44]

In contrast with that treatment, when Congress enacted Section 11(d) (1) of the Exchange Act (also on the subject of securities credit) at the same time as Section 7, it took this regulatory provision outside of the orbit of the Federal Reserve System and placed it within the exclusive province of the Commission, on the theory that the intended impact had nothing to do with the economics of credit, but, rather with the possible violation of fiduciary obligations.[45] These two provisions on the subject of credit on securities serve to shed light on the limitations on the authority granted to the Commission by Congress.

With regard to the non-governmental bodies which have been accorded regulatory responsibility and authority under the Exchange Act, the basic limitations which exist as to the Commission apply similarly to those self-regulatory organizations. However, in addition to imposing affirmative requirements on national securities exchanges to discipline members for willful violations of that Act and the rules

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[42] These are the Securities Act and the Exchange Act. The other statutes administered by the Commission are either supplementations of those two acts (e.g., the Trust Indenture Act of 1939 in relation to the Securities Act; and the Investment Advisers Act of 1940 in relation to the Exchange Act), or they have very specialized application, such as the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, and ch. X of the Bankruptcy Act under which the Commission has special functions.

[43] See, e.g., secs. 11(a), 12(2), and 17(a) of the Securities Act, and secs. 9(a) (1), (2), (3), (4), (5), and (6), and 10 (a) and (b), and 11(d)(1), and 15(c) (1) and (3) and 18(a) of the Exchange Act.

[44] An illuminating and succinct discussion of the legislative history of sec. 7 of the Exchange Act may be found in, Bogen & Kroos, "Security Credit—Its Economic Role and Regulation, "Prentice-Hall, Inc. (1960), pp. 85–98, in which the authors summarize the subject by pointing out that the congressional decision to give the Federal Reserve system exclusive jurisdiction in these areas, as distinguished from the Commission, was to serve the objective of furnishing the authority to an agency which could "apply selective control to specified forms of security credit with a view of maintaining quantitative credit control more effective." Idem at p 98.

[45] See E. Weiss, "Registration and Regulation of Brokers and Dealers." supra n.40 at pp. 85–86. It should be noted that the Commission does have the enforcement responsibility under section 7 the act and the rules and regulations thereunder, but this is a purely prosecutive matter. However, under clause (9) of section 19(b) of the Exchange Act, the Commission does have the authority and responsibility for considering and passing upon whether commission rates and other charges of members of national securities exchanges are reasonable. As to over-the-counter broker-dealers, see sections 15(b)(8) and 15A(b)(8) of the Exchange Act.

thereunder, Section 6(b) of the Exchange Act also requires the exchanges to promulgate and carry out standards of "just and equitable principles of trade". This wider latitude than that formerly accorded to the Commission (the SIPC Act confers new powers upon the Commission in this area) served as the basis for the adoption and enforcement of exchange rules governing, among other things, the segregation of the fully paid and excess margin securities of customers, the lending of such securities, and the use which may be made of customers' free credit balances. Section 15A of the Exchange Act provides comparable scope for the NASD.

It is quite plain from Section 6 of the Exchange Act and the legislative history of the Maloney Act [46] that the self regulatory approach is a technique which Congress has employed to minimize the number of Commission personnel needed to effectuate enforcement of the Federal securities laws. The assumption was that such enforcement would be conducted by the self regulatory organizations with regard to their members and that the Commission was to remain in the background with "reserved control".[47] Thus, the Exchange Act places heavy reliance upon the self regulatory organizations for the day to day regulation of their members.[48] Indeed, having concluded that these self-regulatory organizations had performed with reasonable effectiveness, the Special Study suggested that the deployment of the Commission's limited resources would be better concentrated in other administrative and enforcement areas, and that, accordingly, the Commission's manpower could be correspondingly relieved. Furthermore, because of the lack of authority of the Commission on the subjects of reserves for free credit balances and the segregation of securities to which the attention of Congress was directed in 1941,[49] as well as in the 1963 Special Study,[50] those matters were left largely in the hands of self regulatory organizations for policing with regard to their members. Additionally, members of specified exchanges who were subject to the rules of those exchanges were exempted from the Commission's net capital rule; and reliance was placed on the exchanges to administer and enforce their own net capital rules in lieu of the Commission's regulations on the subject.

Prior to 1967, this regulatory mechanism was reasonably effective. The reliance upon spot inspections as well as the certified annual reports by broker-dealers of their financial condition which are required under applicable rules served as a composite warning system to alert the Commission and the self regulatory bodies of financially troubled firms. However, in early 1967, the Commission became alarmed over an unusually large number of operational problems stemming from the

[46] This was the act which, in 1938, added section 15A to the Exchange Act providing for the creation of registered national securities associations of brokers and dealers engaged in over-the-counter transactions in securities.

[47] See H.R. Rept. No. 1383, 73d Cong., 2d sess. (1934), p. 15; H.R. Rept. No. 2308. 75th Cong., 3d sess. (1938), pp. 4–5; Sen. Rept. No. 1455, 75th Cong., 3d sess. (1938), at pp. 3–4.

[48] That this remains the legislative intent is illustrated by the provisions of sec. 9(f) of the SIPC Act which contemplates that the Commission, by rule or regulation, shall place the day-to-day onus on the self-regulatory organizations for surveillance of the financial condition of their members by prescribing the nature and frequency of financial reports of members and of the inspection activity of such organizations. It was also in that connection that Congress amended sec. 15A of the Exchange Act as part of the Securities Acts amendments of 1964 granting the NASD specific authority respecting financial responsibility of its members. See sec. 15A(b)(5) of the Exchange Act.

[49] SEC report on proposals for amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, House committee print, 77th Cong., 1st sess. (1941), at pp. 28–32.

[50] Special study, pt. 1, at p. 415.

surge in trading volume. The Commission received a substantial increase in the number of communications from public investors complaining about the length of time they were being required to wait for delivery of their securities and the remittances of cash from the sale of securities. Initially, working within the legislative framework, the Commission resorted to and relied heavily upon persuasion to induce the industry to improve its management and financial responsibility. When it became evident that the operational malaise was developing into a possible financial crisis of national scope, the Commission required the exchanges to engage in tight surveillance of larger member firms experiencing incipient difficulties. Some exchanges were required to report almost daily as to the progress of firms experiencing net capital and related financial problems. While the Commission had the authority to institute actions against a good number of the troubled member firms to enjoin the transaction of further business and, in the proper case, to apply for receiver to liquidate their affairs, it was reluctant to take such steps for a number of reasons. The NYSE, relying on its trust funds for the protection of the customers of its members, took the position that funds available to customers of liquidated firms should be administered by its own liquidator. With the use of various techniques, such as the arranging for transfers of customer accounts, mergers, the inducement of infusion of new capital and the gradual liquidations of what may have been left of such firms, the exchange made judicious use of its trust funds to take care of remaining customers in the course of liquidations. Much was done by the exchange to blunt the edge of the overhanging threat of calamity.

The Commission exercised its oversight responsibilities by following events very closely and remaining in constant contact with the individual firms and the exchanges.[51] When finally it became evident that the efforts of the self regulatory bodies might be insufficient to ward off possible permanent danger to the industry and to the investing public, the Commission and the industry recommended that Congress enact legislation providing protection to public investors against loss of cash and securities resulting from insolvency of broker-dealers. The result, the SIPC Act, protects customers' accounts to the extent of $20,000 in cash and a total of $50,000 in cash and securities. The timeliness of that legislation can be appreciated by the fact thta the then existing trust funds of the NYSE were at the point of exhaustion.[52]

The SIPC legislation confers upon the Commission broad new powers in the financial responsibility area.

Similarly with the passage of SIPC, the NYSE and the other self regulatory bodies are in a better position to concentrate their efforts on improving the operational end of the industry, particularly in the areas of management and capital structures and the development and expansion of the depositories and clearance facilities so sorely needed at this time.

The remedy for these imperfections embrace many subjects—the computerization of operations, the standardization of processes, the

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[51] The details of the Commission's activities in this period are set forth in appendix A.

[52] The Exchange subsequently did assess its members for additional contributions to its trust fund to take care of the customers of some insolvent firms in liquidation as well as the customers of some large firms that were in financial difficulties prior to the adoption of SIPC. See ch. IX, *supra*, on "Self-Regulation" at pp. 207–209.

proper training for management and the exercise of management functions in the operational areas, the selection of the most desirable method for dealing with the stock certificate, the needed improvements in the clearance and transfer procedures, and the like. The recommendations found in this report indicate the additional authority the Commission requires to properly perform its task in the operational and management segment of the industry.

3. The need for an early warning system

In 1942, when it had under consideration the broker-dealer annual reporting requirements which were ultimately embodied in Rule 17a–5 under the Exchange Act, the Commission observed that those requirements, together with the Commission's inspection powers, would be an integral element in the arsenal for protection of customers against the risks involved in leaving securities with their broker-dealer.[53]

Later, in 1955, when it had under consideration the expansion of the certification requirements for such reports, the Commission indicated that, with the broader proposed certification requirements, customers having substantial amounts of securities with their broker-dealers "should have the protection afforded through examination of the books and records and the certification of the financial statements of such brokers and dealers by independent accountants." [54] And, when the Commission ultimately adopted the expansion of the certification requirements in 1957, that step represented the Commission's considered view that those certification and reporting requirements constituted a valuable regulatory tool for the protection of a customer in respect of the risks involved in leaving his money and securities with his broker-dealer.[55] This was evidenced not only by the exemption in Rule 17a–5 from its certification requirements accorded to brokers and dealers who do not hold funds and securities of customers [56] but also by the Comission's observation at that time that, as distinguished from inspections upon which it primarily relied for testing compliance with applicable regulatory requirements, the certifications by the accountant were to serve as the barometer of the broker-dealers' financial condition.[57]

The report, which is required to be responsive to the Commission's Form X–17A–5, is designed to reflect the financial condition of the reporting broker-dealer; and, accordingly, it contains details calculated to reveal whether or not the broker-dealer is in compliance with, among other things, applicable net capital requirements. A copy of Form X–17A–5 as currently in use is continued in Appendix B.

To enable the accounting profession to become fully acquainted with the special characteristics of a broker-dealer audit, the Commission delayed adopting the certification requirements until the completion of the publication of a booklet issued by the Special Committee on Auditing Procedure of the American Institute of Accounts [58] entitled

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[53] *National Association of Securities Dealers*, Inc., 12 S.E.C. 322 (1942) at p. 329, n.9.
[54] Securities Exchange Act release No. 5264, Dec. 12, 1955.
[55] See Exchange Act release No. 5560, Aug. 8, 1957.
[56] See Exchange Act rules 17a–5(b)(1) (A), (B), and (C).
[57] "Such inspections are not a substitute for an audit by an independent accountant, but are primarily designed to make certain that the broker-dealer is complying with the Federal Securities Laws and regulations of the Commission. . . ." SEC News Digest, Aug. 8, 1957, p. 3.
[58] This organization is the predecessor in name of the American Institute of Certified Public Accountants, hereinafter referred to as the "AICPA."

"Audits of Brokers and Dealers in Securities" ("1956 Audit Guide"), which had been in preparation for several years up to that time.

When filed, the reports of financial condition are scrutinized by the national securities exchanges of which the broker-dealers are members and by the Commission with respect to other broker-dealers. Failures to make timely filings, as well as the absences of the required certifications, have been dealt with firmly by the Commission. Evidences of financial weakness, as by non-compliance with net capital requirements or otherwise, are watched very carefully and followed up.[59]

Those techniques which had functioned well for regulatory purposes faltered heavily in the 1969–70 climate and the need for an early warning system became apparent. This may be explained as follows. First, the relatively leisurely pace of the annual reporting requirements and the consequent follow up of regulatory activity could not meet the needs of the kinetics which prevailed in the industry beginning in 1967. With the books and records of some brokers and dealers in the poor condition they were at the time, the problem for the auditors became a highly complex and laborious one.

In this connection, upon Commission inquiry, the NYSE responded under date of July 27, 1971 by a letter containing the Exchange's specifications of particular auditing and reporting deficiencies by accountants which, it feels, have been responsible in part for the failure of the Exchange to have been altered to operating and financial problems of certain firms.[60] In fact, the Exchange has instituted suits against certain accounting firms upon the claim that their audit deficiencies were the proximate cause for the necessity, at a later point in time, for the use of the trust funds of the Exchange—funds, which it asserts, it would not have been necessary to expend had the Exchange been alerted in time through proper audit procedure, comment, or communication.

In July 1971 the Committee on Stock Brokerage Accounting and Auditing of the AICPA published for comment an "exposure draft" of a revised audit guide which had been in preparation for quite some time. This revision is more explicit than the 1956 audit guide in certain areas which became significant problems starting in 1967. The Commission is actively cooperating with the Committee in their effort at updating and modernizing the audit guide and in recognizing problems in such areas as the auditing and reporting of securities not readily marketable and the delineation of material matters relating to operations of broker-dealers which must be considered and reported.

In the July 1971 survey on "The Auditors of Wall Street," for the Attorney General of the State of New York, that official concluded, among other things, that the detailed information contained in the reports filed by broker-dealers with the regulatory authorities should be disseminated by the broker-dealers to their customers in a timely fashion; [61] and he further points to the desirability of the conduct of audits on the same date each year, as distinguished from the so-called "surprise" basis required by the various exchanges, since the mechanics

[59] The NYSE, for example, uses a special operations questionnaire ("SOQ") on which it requires ailing member firms to report to it as frequently as is indicated by the seriousness of the situation.

[60] See app. C.

[61] See pp. 31–32 *infra* in this chapter and n. 67 referring to Exchange Act release No. 9404.

involved in the preparation of audits of the larger broker-dealers actually preclude the element of surprise.

The Commission has these suggestions under consideration. On the matter of distributing the complete reports to customers, there are grave questions as to whether the highly technical detail contained in the Form X-17A-5 report primarily as an administrative tool to the regulatory authorities for the revelation of such matters as possible violations of applicable margin requirements, or of the hypothecation rules or of the net capital requirements, would be meaningful to them.[62]

On the subject of early warning systems, the Commission has moved forward on several fronts. On December 1, 1970, it adopted paragraph (j) of Rule 17a-5 which provides that, when a broker-dealer ceases to be a member in good standing of a national securities exchange, it must, within two business days thereafter, file specified, detailed information on his financial condition. This rule also requires an exchange, which takes action causing a member broker-dealer to become a member not in good standing, to notify the Commission and to furnish information to it as to the reasons for such action.[63]

On July 30, 1971, the Commission adopted Rule 17a-11 which provides that, when a firm's net capital falls below applicable requirements, it must provide immediate telegraphic notice to the Commission and to any self-regulatory organization of which it is a member; and, within 24 hours, it must file with them a report containing specified financial information. Additionally, according to the rule, when a broker-dealer makes its required monthly net capital computation [64] and ascertains that its aggregate indebtedness exceeds 1200 percent of its net capital (or that its net capital is less than 120 percent of the minimum requirements applicable to him) he must file information in considerable detail on a new form (form X-17A-11) within 15 days after the end of the month to which the computation relates; and it must continue to file that kind of information on Form X-17A-11 for each month thereafter until, for a period of three successive months, its aggregate indebtedness has been below an amount not exceeding 1200 percent of its net capital (and its net capital has remained in excess of 120 percent of its minimum requirement). The rule also provides that, when a broker-dealer's books and records are not current, it must give telegraphic notice to the regulatory authorities, and, within 48 hours, file a written report on the corrective steps it has taken. Finally, the rule requires a self-regulatory body to inform the commission when such body learns that a member has failed to give any notice or file any report required by Rule 17a-11.[65]

On November 8, 1971, moreover, the Commission adopted a "box count" rule [66] which requires broker-dealers within the ambit of the rule to engage in a quarterly physical examination and count of all of

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[62] These reports are in the public files of the Commission and the exchanges of which a broker-dealer is a member, and they are accordingly open to inspection by anyone upon demand.

[63] The details of paragraph (j) of rule 17a-5 are contained in Exchange Act release No. 9033, Dec. 1, 1970.

[64] This is provided for by rule 17a-3(a)(11) of the Exchange Act.

[65] Adoption of rule 17a-11 was announced in Exchange Act release No. 9268, July 30, 1971. The release contains the text of the rule.

[66] Rule 17a-13, See Exchange Act release No. 9376, Nov. 8, 1971.

the firm's securities and those of its customers; and, in addition, to verify all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, and securities otherwise subject to its control but not in its physical possession. In comparing the results of its examination and verification with his records, any differences must be noted, and, within seven days, the unsolved differences must be positioned to the firm's books and records. Individuals engaged in the count and verification or in the entry of the stock difference records should be persons whose functons do not include the handling of securities or the maintaining of the required records. Scope is afforded in the rule for the count, examination, and verification to be conducted under specified conditions on a cyclical basis covering the entire list of securities, instead of on a date certain. In connection with these new requirements, the Commission has amended the annual report form (Form X–17A–5) to reflect the information required by Rule 17a–13.

On November 26, 1971, the Commission issued for comment proposed amendments to Rule 17a–5 (new paragraphs (k), (l), (m) and (n)) which would require every member, broker or dealer to send to each customer an annual report of financial condition and results of operations together with specified supplementary information and a quarterly report containing specified information relating to the business.[67]

4. Ease of entry into the business

A detailed discussion is found in a subsequent part of the report as to the need in the public investor interest to establish higher standards of entry into the broker-dealer business, in light of the rapid rate of demise of inexperienced, unseasoned and irresponsible broker-dealers to the detriment of their customers and the expense of SIPC.[68] Reference is made there to the steps which the Commission has taken and has under consideration to eliminate, as far as possible, financially deficient and irrespondible people from placing themselves in a position to wield harm to the public investor.

CONCLUSIONS AND RECOMMENDATIONS

The years 1967–1970 were a period of great turmoil and upheaval for the economy in general and the securities industry in particular. During this short period more than a dozen NYSE member firms failed, and another seventy or more were merged into or aquired by other firms. Further, numerous smaller brokerage firms, members of regional stock exchanges and the NASD, were also merged or liquidated. The losses of these firms, which have not been fully tabulated, already exceed $130 million. Although a substantial number of customers have or will be assisted to the Trust Fund of the NYSE, customers of the liquidated and merged broker-dealers have nevertheless been adversely affected by having had their funds and securities frozen or otherwise unavailable for substantial periods of time.

It is rather paradoxical that the securities industry was confronted with serious problems at a time when trading volume and securities

[67] See Exchange Act release No. 9404, Dec. 3, 1971.
[68] See ch. VII *infra.*

prices were at all time highs. While increased trading volume should have caused increased revenues and profits, it in fact caused severe operational problems at many firms with concomitantly high expenses. Although various factors, including the quality of management and the financial and organizational structure of the firms were contributory causes, the primary cause of the industry's problems was its inability to accurately, promptly and inexpensively record and process the substantially increased trading volume of the late 1960's This inability resulted in what has been termed the "Paper Crunch." Brokerage firms were literally inundated with pieces of paper of all types, sizes, quality, descriptions and values which had to be received, processed, recorded and delivered, all within a short time span. This trading volume was rapidly increasing from 3,042,000 shares per day in 1960, to 12,971,000 in 1968.[69] During this period many firms had only the most rudimentary automated equipment or were in the process of designing or attempting to implement as yet untested automatic processing systems to replace the manual systems then in use.

This lack of capacity to handle the increased trading volume necessarily resulted in severe operational problems as the firms' back offices simply could not handle this volume. The "Paper Crunch" became so severe that the exchanges reduced trading hours and even closed one day per week in an effort to resolve these problems. However, these measures were at best only partially effective.

As a result of the "Paper Crunch" many brokerage firms soon become unable to accurately and promptly record and process securities transactions and were unable to properly maintain their books and records. This operational chaos brought to light and exacerbated other structural problems inherent in the securities industry at that time.

It is important to remember that the securities industry was for the most part comprised of firms which were private partnerships. This form of business organization is inherently not conducive to the formation and retention of substantial sums of equity or permanent capital, particularly when partners, for tax or personal reasons, are able to withdraw capital. Additionally, many firms which were organized in the corporate form were close corporations with very "thin" capitalization. Further, many firms, whether partnerships or corporations, relied upon securities contributed by partners or subordinated lenders for capital. Consequently, the vast sums of money which were required to acquire and install the automated data processing ("A.D.P.") systems necessary to adequately handle the increased trading volume were not readily available. An additional complicating factor was the dearth of trained and competent personnel capable of handling the increased workloads. Thus, while the firms had not installed the necessary A.D.P. equipment, they also lacked the personnel to service the systems which were available. Many firms reacted to these problems by contracting to acquire and install A.D.P. systems at substantial cost and by over-working their existing personnel and/or "pirating" the skilled personnel of other firms. Thus, these firms sustained substantial increased operating expense in labor and equipment costs without any immediate meaningful improvement in productivity or processing.

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[69] NYSE Fact Book 1971.

Meanwhile the "Paper Crunch" continued escalating costs even further as processing and accounting errors were mounting causing firms to undertake additional expenses in an attempt to resolve these errors.

However, even the attempt to resolve the problem through the acquisition and installation of A.D.P. systems caused complications as many firms abandoned existing systems for the new A.D.P. systems which were unproven. Indeed, a number of brokerage firm failures are directly attributable to conversions to A.D.P. systems which were not properly planned or implemented.

Unfortunately the downturn in trading volume was not a cure to the operational problems of the "Paper Crunch." The downturn in trading volume and securities prices during the 1969–70 "Bear Market" which was supposed to allow firms to "catch up" on their paperwork processing resulted in a financial crisis which ultimately caused many firms to fail. Many firms which undertook substantial expansion during the Bull Market and contracted for additional personnel and equipment to solve the "Paper Crunch" had substantial ongoing overhead expenses, but with the decreased trading volume revenues were not sufficient to meet their costs. Further, as many firms were thinly capitalized, with little equity capital, and further were capitalized with securities whose values were now rapidly declining, these firms did not have sufficient resources to meet the many financial demands being made on them. Thus, the lack of adequate permanent capital coupled with the shrinking capital provided by securities whose values were declining rendered many firms unable to survive the financial problems caused by decreasing revenues and increasing expenses during the Bear Market.

The major self-regulatory organizations which have responsibility for supervising the financial and operational condition of their members were equally unprepared. In the first instance, the self-regulatory organizations had not expected the surge in trading volume, nor had they adequately planned or prepared for the development of sophisticated industry-wide systems to handle this volume. The systems which were utilized in 1968 were essentially the same as those utilized in 1960. The operational systems of the individual firms, particularly certain of the large "retail" firms, were not adequate for their purposes. Only when the operational problems reached crisis proportions did the self-regulatory organizations act decisively to improve operational systems.

Further, in many instances, the self-regulatory organizations were reluctant to take decisive action such as suspending a firm.

Apparently, the self-regulatory organizations felt that if the firms were given sufficient time and if market conditions could improve, these problems, which were often viewed as "temporary" or "cyclical" rather than structural, would be resolved. Unfortunately, this approach was not always successful.

While under a capitalistic system some business failures are inevitable, and although it is not our intent or purpose to prevent inevitable failures, it is nevertheless our objective, in the event of a brokerage firm failure, to provide maximum protection for customer funds and securities. The recent SIPC legislation will greatly assist in the realization of this objective. However, it is not the total solution as its protections are limited. Moreover, the $1 billion in Treasury funds which are available in the event they are needed to accomplish the goals of SIPC are not an inexhaustible amount and also, as public funds, require protection.

This report attempts to identify and discuss in significant detail the various unsafe and unsound practices of the securities industry which caused the staggering losses of recent years. Following this section is an enumeration of actions already taken to eliminate certain of these practices. The particular conclusions and recommendations, including recommendations for additional legislation which may be needed to eliminate those unsafe or unsound practices, follow the discussion of the actions taken.

CORRECTIVE ACTION TAKEN BY THE COMMISSION UNDER SECURITIES INVESTOR PROTECTION ACT OF 1970 AND OTHER EXISTING LAW

1. Protection of customers' funds and securities

A. Pursuant to the authority conferred upon the Commission under SIPC, the Commission has proposed for adoption several rules for the protection of customers' funds and securities and the amendment of existing rules in this area. Proposed Rules 15c3-3 and 15c3-4 relate to the protection of customers' credit balances and securities.[70] The proposed rules impose restrictions and the establishment of reserves respecting the use of customers' funds in a manner designed to insure their safety. Under such rules the broker-dealer must verify and reconcile his bank statements within two weeks after receipt. When adopted, the rules will obligate a broker-dealer promptly to reduce to possession or control customers' securities which have been paid for, and in the absence of doing that, to place their cash value in a reserve account. The rules will further require the mandatory buy-in of customer securities which have not been reduced to possession or control within designated periods of time. Such rules when adopted should go far to correct a good number of abuses of customers' funds and securities which occurred during 1968-70 period. Also amendments have been proposed to the hypothecation rules, Rule 8c-1 and Rule 15c2-1 under the Exchange Act, which will restrict the use of customers' securities not only with respect to hypothecation but also as to lending or borrowing of such securities by the broker-dealer.[71]

B. The Commission directed its attention to the stock record difference problem by adopting Rule 17a-13 [72] which requires quarterly box counts by broker-dealers, the certification of all securities not in a broker's possession, and the recording of the results in their records, with such information to be included in their annual reports of financial condition. Rule 17a-13 is an effort to meet the deficiencies in the internal controls and procedures for safeguarding securities reflected by material amounts of unresolved security differences, suspense balances and unverified transfer items. It establishes a minimum standard of control over securities for broker-dealers. To help solve

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[70] Exchange Act release No. 9388, Nov. 8, 1971.
[71] Ibid.
[72] Exchange Act release No. 9376, Nov. 8, 1971.

problems in the dividend area, the Commission adopted Rule 10b–17 [73] to require the timely announcements of record dates.

2. Perfection of early warning system

The Commission has adopted rules under the Exchange Act which will improve the ability of the Commission and the self-regulatory organizations to identify promptly firms experiencing operational and financial difficulties.

In December 1970, Rule 17a–5(j) [74] was adopted to require an immediate report of financial condition from broker-dealers ceasing to be members in good standing of a national securities exchange. On July 30, 1971, Rule 17a–11 was adopted which requires broker-dealers to report immediately to the Commission and all appropriate self-regulatory agencies if it violates any net capital rule or if its books and records are not current; a financial report must be filed within 24 hours after the net capital deficiency occurs. Additionally, a broker-dealer must report its financial and operational condition within 15 days after the end of any month in which its net capital ratio is in excess of 1200 percent.[75]

3. Improvement of clearance, delivery and transfer procedures

The Commission has also taken steps to identify and correct operational and financial problems in the industry by other means. On April 19, 1971, the Commission convened a meeting of the major self-regulatory organizations to discuss the immediate and long term solutions for increasing the operational capacity of the securities industry.[76] A conference was sponsored by the Commission on June 29, 1971, to discuss various proposals for dealing with the stock certificate.[77] A series of meetings beginning in June 1971 were held between the Commission's staff and the Federal bank regulatory authorities with respect to the regulation and performance of transfer agents. The Commission commenced public hearings on October 12, 1971, concerning among other things, the restructuring of the securities markets.[78]

On November 11, 1971, the Commission requested the Congress to supplement its Fiscal 1972 Budget to allow staffing up to its authorized strength and the addition of 146 employees. A total of 89 employees have been requested to assist in the financial and operational area: 27 to review financial and operational reports submitted by broker-dealers; 15 non-NASD broker-dealer inspectors; 25 NASD broker-dealer inspectors; 16 to coordinate oversight duties with the various self-regulatory organizations; and 6 to work on a special project to eliminate or immobilize the stock certificate.

4. Financial information for customers

An amendment to Rule 17a–5 which would require broker-dealers to furnish certain financial condition to their customers has similarly been proposed.[79] The need for a rule to require a broker-dealer to more adequately report to customers its financial condition has become

[73] Exchange Act release No. 9192, June 7, 1971.
[74] Exchange Act release No. 9033, Dec. 1, 1970.
[75] Exchange Act release No. 9268, July 30, 1971.
[76] Exchange Act release No. 9155, Apr. 19, 1971.
[77] Exchange Act release No. 9240, July 2, 1971.
[78] Exchange Act release No. 9315, Aug. 26, 1971.
[79] Exchange Act release No. 9404, Dec. 3, 1971.

apparent with the operational and back office crisis of 1968 and the subsequent failure of numerous firms who held funds and securities of customers. The rule will require sending directly to the customer financial statements substantially equivalent to those he would receive if he were investing in a public company as well as other data relevant to his decision as to whether he should transact business with such broker-dealer.

5. Improvement of entry standards

Additionally, the Commission has proposed an amendment to Rule 15c3-1 to increase minimum capital requirements for entrants into the brokerage business, and an amendment to Rule 15b1-2 has been proposed for public comment to insure conservative and proper operation at the outset by new entrants.[80]

6. Commission enforcement activity

An important aspect of the Commission's program to protect investors has been the enforcement actions taken by the Commission against broker-dealers for violations of the bookkeeping and financial responsibility rules.[81] Other actions have been taken to require brokers, in raising capital from customers and prospective customers, to comply with the requirements of federal securities laws.[82]

INDUSTRY ACTIVITIES ENCOURAGED BY THE COMMISSION

1. Net capital

Among the actions of the various self-regulatory agencies involving the financial condition of their members, which were encouraged and participated in by the Commission, were revisions of the several exchanges' net capital rules to tighten up the financial responsibility of their members.[83]

As noted at several points in the report, basic differences in both the application and interpretation had developed between the net capital rules of the Commission and the NYSE, and while some of these differences have existed since members of the NYSE were exempted from the Commission's net capital rule, many of them developed during the operational and financial crisis which occurred at the end of the 1960's. However, based on the financial difficulties experienced by its members, the NYSE, after a considerable amount of study, has revised its net capital rule.[84] The changes fall into six categories. Most of the changes were implemented on August 1, 1971; others will not be effective until future dates.

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[80] Exchange Act release No. 9288, Aug. 13, 1971; Exchange Act release No. 9411, Dec. 9, 1971.

[81] See, e.g. *In re Goodbody & Co.*, Exchange Act release No. 9122, Apr. 2, 1971. *In re Dempsey-Tegeler & Co., Inc.*, Exchange Act release No. 9330, Sept. 10, 1971; *In re Gregory & Co.*, Exchange Act release No. 9247, July 19, 1971; *In re Francis I. duPont*, Exchange Act release No. 9391, Nov. 18, 1971; *In re Amott, Baker & Co., Inc.*, Exchange Act release No. 9070, Feb. 3, 1971; and *In re Baerwald & Deboer*, Exchange Act release No. 9273, Aug. 2, 1971.

[82] See, e.g. *In re Bache & Co., Inc.*, Exchange Act release 9266, July 28, 1971; *In re Walston & Co., Inc.*, Exchange Act release No. 9362, Oct. 7, 1971; and Exchange Act release No. 9412, Dec. 9, 1971.

[83] See, e.g., NYSE M. F. Educational Circular No. 336, July 16, 1971.

[84] Details respecting the former approach by the NYSE to its net capital rule and the revisions embodied in NYSE M. F. Educational Circular No. 336, July 16, 1971, are noted at various points in ch. II, III, and IV.

A. Haircuts

Greater haircuts (percentage deductions from market values) are imposed on proprietary security positions under certain circumstances. Commercial paper, depending on its rating, must now be haircut. Further, additional haircuts are imposed on a particular position if the position by reason of its size represents a significant portion of the member's net capital.

B. Short security differences

The revision requires a 100 percent charge to be made to net capital for short stock record differences which are unresolved either within 45 days of the annual surprise audit or 45 days of discovery. There is no netting with or offset for long stock record differences. The charge for short security differences is to remain in effect until the differences are resolved.

C. Reduced ratio and phasing requirements

The maximum ratio of aggregate indebtedness to net capital was reduced from 20 to 1 to 15 to 1. The adoption of new Rule 326 prohibits a member firm doing a public business from expanding its business if its net capital ratio exceeds 1000 percent or if its capital withdrawals scheduled for the succeeding six months would cause the net capital ratio to exceed 1000 percent. Similarly, the new rule requires a member firm to reduce its business when its net capital ratio exceeds 1200 percent after giving effect to all the prospective withdrawals for the following six months. Further, the revised net capital rule suspends the repayment of capital, either subordinated or equity, if the withdrawal raises the firm's net capital ratio over 1200 percent.

D. Minimum capital requirements

The new rules raised the minimum capital requirements for member firms carrying customers' accounts from $50,000 to $100,000. The minimum requirements for member firms clearing on a fully disclosed basis is raised from $25,000 to $50,000.

E. Permanency of capital

In addition to the above mentioned changes restricting capital withdrawals if a member firm's ratio after giving effect to the withdrawal is more than 1200 percent, other provisions were adopted to render the firm's capital more permanent. All securities contributed as capital must be fully paid. All subordinated capital must be furnished pursuant to the standard form of agreements supplied by the Exchange which, by their terms, require capital to be contributed for a minimum period of one year, and provide that capital may not be withdrawn except upon six months notice and upon written Exchange approval. A favorable tax ruling that the interest paid on the agreement is a business deduction must be obtained before these new form agreements become effective; and, after such ruling, member organizations are given up to two years to revise their subordination agreements so as to be in conformity with the standard form agreements.

F. Temporary infusions for limited number of underwritings

Temporary infusions of capital are permitted three times a year for the purpose of meeting unusual underwriting commitments. This kind of captial may be provided only by officers, stockholders, partners, or other insiders and may include margined securities. The capital contributed by this method cannot be repaid if its members firm's capital ratio exceeds 1000 percent.

Officials of the Exchange testified before the Subcommittee on Commerce and Finance of the House of Representatives Committee on Interstate and Foreign Commerce on Tuesday, August 3, 1971 that these changes in the NYSE net capital rules allow less room for interpretation than the provisions of the old net capital rule.

2. Operational area

A. Improved clearance procedures and depository arrangements

In the operational area major progress has been made in reducing the cost and disruption arising from the staggering amount of paper work required in the settlement and transfer process of securities transactions. Among these measures have been the establishment by the National Clearing Corporation (NCC), now operating on a pilot basis, of a nationwide net-by-net clearance and settlement system for over the counter securities which promises to minimize substantially the handling of certificates and speed up the entire transaction process with regard to those securities which have accounted for the bulk of the certificate handling problems. In October 1971, the Midwest Stock Exchange began implementing its continuous net settlement system. The Pacific Coast Stock Exchange also has a net-by-net clearance and settlement system as well as a central certificate depository.

Additionally, central depositories for certificates have been expanded to include listed issues of more than one exchange; banks have started making use of these depositories, and steps are under way to encompass mutual fund investment companies, other institutions and regional exchanges.

The self regulatory organizations have currently under development systems designed ultimately to lead to automated trading and automated clearing and settlement of transactions.

In addition to these major accomplishments, transfer agents have commenced using jumbo certificates whenever possible to avoid the multiplicity of smaller denomination stock certificates. Additionally, in January 1971, the Stock Transfer Association and the New York Clearing House issued a new set of guidelines relating to necessary documentation in light of the changes effected by the Uniform Commercial Code respecting transfers by fiduciaries.

B. Back office—improved management and monitoring

In the area of the back office, the self regulatory organizations have stepped up their surveillance program. The NYSE now conducts special inspections of member firms on segregation, dividend control, internal security and compliance with the Exchange's proxy regulations, in addition to the comprehensive annual inspection. Member firms are now required to report monthly on a form calling for current financial information which is also designed to measure data against an exposure index on the subjects of transfers, aged dividends, various difference accounts, and the like. The Amex has developed the FACS (feed back and analysis control statistics) program based on specified yard sticks on performance, classified in relation to different types of firms (e.g., retail, institutional, and regional) in such critical areas as paper processing, customers' service, money management, computer operations, and similar topics. Under this program, certain Amex member firms some of which are also NYSE members submit monthly data on the basis of which that exchange renders a report indicating the variations, if any, from the norm and suggesting improvements in the weak area.

C. CUSIP

Further, with the implementation of the CUSIP number system the industry has taken a step towards the standardization of data inter-change, a necessary pre-condition for the automation of the trade execution and consummation process. The CUSIP number is an 8 character number specifically, uniquely and permanently identifying the issuer of a security and the specific security. The number was developed by a committee of the American Bankers Association formed in 1964 and consisting of representatives of the banking and and securities industry and their regulatory and self-regulatory organizations. The first directory of these numbers was published in June, 1969. Since then, the self-regulatory organizations have adopted several rules directed towards the wide-spread utilization of the number. Beginning January 1, 1971 no issuer listed on NYSE or Amex could issue a stock certificate which did not contain the CUSIP number. Beginning April 1972 the clearing corporations of the New York, American, Boston, Midwest, Pacific Coast and Philadelphia-Baltimore-Washington Stock Exchanges and the National Clearing Corporation of the NASD will not accept clearing or settling documents which do not contain the CUSIP number and the clearing and settling documents issued by these clearing corporations will include the CUSIP number. The use of the CUSIP number to identify securities has been fostered by the Commission's requirement that it be used on specified official reports filed with the Commission.

D. Standardization of operational and financial reporting

Recently, the NYSE, Amex and NASD developed a standardized periodic operational and financial report to replace their existing, individual reports.

ADDITIONAL MEASURES FOR THE COMMISSION AND THE INDUSTRY

Apart from the need for pursuing to conclusion the rule proposals for the additional protection of the funds and securities of customers, for the establishment and maintenance of an effective early warning system, and for tightening the requirements for entry into the broker-dealer business, as well as for carrying out its responsibility for implementing the rules already adopted in those areas through vigorous inspection and enforcement programs, the Commission envisions the necessity for further remedial steps on the following subjects:

1. Regulation of the process of effecting securities transactions

There is no area of the securities business which offers more opportunity for reducing costs as well as exposure to the kind of disruption which resulted in loss to customers during the 1969–70 period, than the improvement and modernization of the systems for clearing, settlement, delivery and transfer of securities. It was the archaic method of achieving this simple objective which nearly drowned the financial community in a tidal wave of uncontrolled paper. It is clear that modern communications and computer technology have now advanced to a point where the transfer of stock ownership, the payment therefor, and the documents controlling and recording the transfer of ownership and payment can be dramatically simplified. Considerable progress has been made in this direction. The Banking and Securities Industries Committee, at least four stock exchanges, and the NASD have made important strides toward modernized clearance, settlement and delivery systems. What is needed now is a force to direct and accelerate the evolution of these efforts into a single, integrated and nationwide system of securities clearance, settlement and delivery. From the individual and disparate attempts to improve the handling of the certificates and the process of clearance and settlement there have evolved the basic ingredients for such a system. The most recent increments are the CCS despository developed by the NYSE, the continuous net-by-net settlement system developed by the Midwest Stock Exchange, and the net-by-net settlement system of NCC adopted by the NASD, the latter in response to the Commission's insistence that a clearing mechanism for over-the-counter transactions be created.[85] Indeed, it was in the over-the-counter area that the major paperwork problems were generated between 1968 and 1970.

Each is performing a valuable function which should be further developed. However, such development must be controlled and directed in a manner which would keep each system open-ended and compatible with other systems so that, together, they can evolve and be combined into the kind of a national system which modern technology makes possible and the public is entitled to expect.

The Commission has specific responsibility and authority in this area because of its oversight of the self-regulatory organizations including the powers granted under Section 19(b) of the Exchange Act authorizing the Commission to alter or supplement the rules of exchanges "to insure fair dealing in securities traded in upon such exchange" in respect of "financial responsibility of members" and "the time and method of making settlements, payments and deliveries", as well as under Section 15 A of the Exchange Act with regard to its oversight of national securities associations relative to its approval of rule changes, and, finally, under Section 15(c)(3) of the Exchange Act as amended by Section 7(d) of the SIPC Act, providing that no brokers or dealer shall effect transactions in securities "in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits of credit balances".

The Commission will use this authority as necessary and appropriate to pursue the following objectives and goals:

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[85] The net-by-net settlement system was developed by The Pacific Coast Stock Exchange.

1. The Commission will monitor, and actively consult with members of the industry, regarding the development of automated systems for each stage of the transaction handling process: order entry, execution, comparison, clearance, settlement, custody and transfer. It has authorized and Congress has approved funds for a special unit within the Commission to accomplish these goals.

2. The Commission will seek to insure that the clearance and settlement process will properly interface with certificate depositories throughout the country, and that the certificate depositories will be technologically compatible with each other.

3. The Commission will seek to insure that the certificate depositories grant access to all broker-dealers and other responsible financial institutions on a reasonable and non-discriminatory basis.

4. The Commission will continue to encourage the development of NCC as a national system for handling over-the-counter securities.

5. The Commission will oversee the development of the various industry-wide clearance systems to assure their compatability with the objective of the establishment of an efficient, unified, nationwide clearance system.

6. The Commission will actively assist, by various measures including its rule making powers, the efforts of industry groups attempting to alleviate operational problems by standardizing the documents which form the backbone of securities transaction, particularly those documents which control the movement of or accompany stock certificates.

7. The Commission will assist, through the use of its rule making powers, the efforts of securities and banking industry operations groups which are attempting to alleviate problems in the transfer and registration process by standardizing the form and format of stock certificates.

8. The Commission will retain jurisdiction over all entities performing the clearance and settlement functions.

9. The Commission will determine that securities depositories are effectively regulated, and will seek to insure that a system of such depositories is expeditiously developed to meet the nation's needs.

10. The Commission, in cooperation with bank regulatory authorities, will seek the development of communication channels between brokers and banks with a view to determining how to bring about, during this decade, the instantaneous execution and settlement of securities transactions by means of real time crediting and debiting of accounts and registration of stock ownership.

2. The transfer, registry and depository functions

The function of the transfer agent and registrar has gone largely unregulated. The substandard performance of transfer agents was a significant contributing factor to the paperwork crunch of the 1967–70 period. The transfer function is an integral part of the securities handling processes and to the extent transfer agents and registrars fail to meet specified performance levels, the settlement and the transfer process suffers. With regard to any permanent effort to modernize the handling of securities and the clearance and settlement process, transfer agents and registrars would necessarily play an important part. The diffusion of transfer agents and registrars, in terms of location, facilities and size, gives rise to various levels of service and capability. The principal transfer agents, the banks, like the brokerage firms, were to a large extent victims of trading volume which they had not foreseen and which they could not cope with. They had not sufficiently automated and did not have enough personnel. They also had the problem of dealing with the brokerage community, which did not hold up its side of the transfer task. The wrong stocks were delivered for transfer, or the right stocks were delivered to the wrong banks, or the brokers did not complete the paperwork attached to the certificates, or did not pick up promptly the securities after transfer.

When all is said by way of mitigation, however, the fact remains that the transfer and registry of certificates was a significant bottleneck in the processing of transactions. The power of the bank regulatory officials over the transfer function is not specific. Rather their concern is whether the performance of the transfer function may endanger the financial stability of the bank.

In an effort to indirectly deal with the problems of transfers, in September 1968, the Commission put out for comment Rule 10b–14 under the Exchange Act, the effect of which would be to impose upon issuers of publicly traded securities the duty to maintain facilities reasonably designed to effectuate the prompt issuance and registration of transfers of securities. The proposed rule, based on the Commission's anti-fraud and anti-manipulation powers, was the subject of considerable critical comment, and it has not been adopted.

Most transfer agents of an issuer are also the disbursing agents for dividends and interest paid on the issuer's securities, although in some instances separate parties perform this function. The brokerage community has experienced serious communication problems with the transfer and disbursing agents in the past involving two important areas. Confirmation of open transfer items by brokers have been difficult to obtain from transfer agents. In addition, disbursing agents do not reveal the certificate numbers on which they are paying a broker interest or dividends. Rather it is the practice of the banking industry to issue a check for the total amount due a broker without identifying the certificates upon which the distribution is paid.

The unavailability of precise information in these areas has created a number of problems for the brokerage industry. Brokers are frequently unable to confirm the existence of aged transfers, thus frustrating efforts to identify locations of customers' securities. Not being able to connect a particular distribution to a particular certificate has led to significant problems for brokers in the dividend and interest receivable area.

Although many of the organizations performing transfer agent and registry and disbursing agent work are banks or trust companies, regulation of them by the Commission with respect only to the performance of such work would appear justifiable in view of the foregoing and also because the performance of transfer, registry and disbursing functions are not, at least as a practical matter, regulated by banking authorities and are more a part of the securities transaction process than the banking process. The regulatory vacuum should be filled in order to prevent transfer, registrar and disbursing agents from impeding the flow of certificates and adversely affecting the whole securities transaction handling process.

All existing depositories are operated by self-regulatory organizations subject to the administrative jurisdiction of the Commission. Depositories could, however, be established by entities other than those regulated by the Commission, and this would create problems in view of the Commission's authority over related clearance and settlement function, and its concern for the development of a single unified nationwide system of processing securities transactions.

Accordingly, to correct the deficiencies in these areas and to implement necessary standards of qualification and performance, the Commission seeks legislative authority to require individuals and institutions performing the transfer and registry function to be subject to minimum standards of performance and unformity regarding their function in the securities handling process. In addition the Commission seeks legislative authority to insure that all entities performing a depository function are subject to regulation by the Commission with regard to their development, qualification, performance and rules, insofar as each relates to the depository function but not with respect to those aspects of a depository more appropriately the concern of state and Federal bank regulatory authorities.

3. *Self-regulation*

The self regulatory organizations were under severe stress during the 1967–70 period as a result of the unprecedented financial and operational problems of their member firms. Their problems arose from the absence of adequate means to detect, identify and correct problems of unprecedented nature and magnitude. Although the problems were industry-wide, they had their most significant impact upon the larger firms, most of which were members of the NYSE. Consequently, the focus of examination of the performance of the self-regulatory organizations has been on the NYSE.

A. *Improvement of monitoring devices*

The methods employed by the self-regulatory organizations to detect operational inefficiencies and financial inadequacies of broker-dealers were demonstrated to be insufficient to be able to single-out those broker-dealers which needed closer surveillance and required the institution of corrective measures or the imposition of limitations on their operations. The Commission recognizes the need of accurate and timely information to be generated by broker-dealers for their own use and for use by the Commission and the self-regulatory organizations as a basis for determining financial and operational difficulties at an early stage. The chapter of this report entitled "The Need for an Early Warning System" details the various steps taken by the Commission and the self-regulatory bodies to establish reporting methods and forms for this purpose.

The reporting forms required by the Commission and the self-regulatory organizations overlap as to the information required. These reports are in different formats and have different dates for which the reports speak. By way of example, the NYSE in the past has required member organizations to file three short form financial questionnaires and four operational questionnaires yearly as well as monthly reports on fails-to-receive and fails-to-deliver, profit and loss, capital withdrawals and additions, etc. Efforts are underway to adopt a uniform industry-wide reporting form. The report will not only improve the regulatory aspects of the industry but also will assist the broker-dealer in assessing its own financial and operational condition for use as an internal management report. The management surveillance program (FACS) initiated for members of the Amex is one type of program that has been beneficial to brokerage firms.

While only thirty firms were reporting on the FACS program in December 1970, at the present time, over 80 firms (all dual members) are reporting monthly on FACS, an estimated 70 percent of the listed business done in New York. Moreover it is anticipated that within two months, all Amex member firms will be required to report on FACS since the FACS information will be included as part of the industry's consolidated report; the NYSE intends to require the use of part of the FACS program for its sole members after the adoption of the consolidated report. At the present time FACS reports back to firms concerning their standing operationally in relation to the other firms of similar type. In addition, where a firm is out of line, such firm is required to advise FACS of the remedial or corrective action it will take or has taken and in some instances the American Stock Exchange offers advice to troubled firms. In the future, FACS reports will be expanded to include financial information as well. The operating budget of FACS has increased from $25,000 at the time of the passage of the SIPC Act to approximately $150,000 at this time and will be expanded to an annual $250,000 budget starting with the adoption of the joint report.

The Commission plans to develop with the self-regulatory organizations programs with a view to having the self-regulatory organizations improve the quality of examinations of broker-dealers and the reports filed by such broker-dealers; improve the training and increase the number of examiners; improve the frequency of examinations of member organizations; and improve coordination and cooperation among the self-regulatory organizations and between the self-regulatory organizations and the Commission.

B. Coordination of surveillance efforts

A significant number of broker-dealers are members of several exchanges as well as the NASD and thus file reports with several or all of these organizations as well as the Commission. The larger self-regulatory organizations have taken primary responsibility for the surveillance of dual member organizations. While this has provided some efficiencies by eliminating unnecessary duplication, it has also caused the other self-regulatory organizations to have deficient information concerning their own members. As a result, a situation exists where either a member withdraws or is suspended from membership on the exchange primarily responsible for its activity and conduct causing the other exchanges to lack sufficient information to perform their own self-regulatory responsibilities. The exchange which suspends a member, if it does not act promptly following the suspension may lose jurisdiction to take disciplinary action for violations causing suspension. Therefore, steps must be taken to assure the free exchange of information and coöperation among the various self-regulatory organizations and between such organizations and the Commission.

C. Commission's oversight

The self regulatory approach traditionally has been relied upon to supervise and regulate broker-dealers under Federal securities laws. As this report indicates self regulation did not fully carry-out the design intended for it by Congress. However, it is the Commission's view that the self regulation is a sound concept which should not be replaced by government regulation. The deficiencies in the self regulatory process disclosed in this report can best be corrected by strengthening the Commission's capacity to engage in oversight activities. With the additional funds, which the Commission requested in its supplemental budget submission for fiscal year 1972, 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 Commission and self-regulatory wide basis the broker-dealer examination programs.

Further, with additional inspection personnel the Commission plans to: inspect all non-NASD members after registration and annually thereafter; inspect broker-dealers for "cause" (i.e., where the Commission has reason to believe a firm is having financial or other difficulties); and inspect NASD and exchange members on a sampling basis to determine whether the self-regulatory organizations are doing an effective job of detection and taking of appropriate remedial action.

The self-regulatory organizations have also taken steps to intensify their inspection and supervisory responsibilities. For its fiscal year which ends on September 30, 1972, the NASD has projected an increase of its staff with 64 persons assigned to the examining staffs in the NASD's 14 district offices. This means that the NASD will have 71 examiners to examine approximately 4,500 member organizations.

D. Additional measures for more effective control over the self-regulatory process

In order to render the self-regulatory system more effective, the Commission believes that modifications in the self-regulatory system are necessary to correct certain existing defects.

The experience of the last few years indicates that the Commission's present authority is insufficient to insure fair and effective self-regulation in the areas of rule-making, enforcement and disciplinary proceedings. In particular the Commission's present authority over the rule-making of the self-regulatory organizations is somewhat cumbersome and does not always allow the Commission to act promptly and effectively where a rule or proposed rule is or may be injurious to the public interest. Also, the Commission is presently unable to directly enforce the rules of the self-regulatory organizations against their members, and its authority to review and alter disciplinary actions taken by the stock exchanges is nonexistent and in the case of the NASD, limited.

Therefore, the Commission believes that the public interest would be better served if it had the authority to approve or disapprove any

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new rule proposal or any proposed amendment, to supplement or to repeal an existing rule as well as to require amendments and supplements and the authority to abrogate rules.[86] Further, the Commission believes that it should be granted the authority to directly enforce the rules of the self-regulatory organizations. Such authority was previously recognized as being necessary and was included as part of the Commission's legislative program for 1941. Additionally, the Commission should be granted the authority to review all disciplinary actions taken by self-regulatory organizations upon appeal by any affected party or on the Commission's own motion and that this review authority should include the power to affirm, dismiss or modify any penalties in any manner it deems necessary or appropriate in the public interest and to insure the fair administration of discipline by the self-regulatory organizations. However, it should be noted that although these modifications would give the Commission increased authority over the self-regulatory organizations, it is the Commission's expectation that these powers would be exercised only infrequently.

4. Improvement of adequacy and permanency of capital

During the 1967–70 period under review many broker-dealers, some of them large retail houses, were found to have inadequate and impermanent capital in relation to the needs of their businesses. Many broker-dealers, including those which had to be liquidated, were poorly financed and in addition relied to an excessive degree on debt financing which was subject to withdrawal on short notice. Much of the debt financing was represented by subordinated loans or subordinated accounts of customers and of others closely affiliated with the broker-dealers. The securities in these subordinated accounts are of course subject to substantial price fluctuations. In a downward market when these accounts were most needed their value fell, and such accounts did not serve their purpose. Moreover, this form of capital, unless a cash loan or deposit, did not result in an increase in the firm's working capital. To the contrary, because the firm usually paid interest upon the value of the securities in the account without a corresponding use of the securities, the subordinated accounts represented only a burden upon the firm. A good deal of the funds which the securities industry operated with consisted of customers' free credit balances and loans or deposits received upon the hypothecation or lending of customers' securities. While the customer was usually appraised of the fact that his funds left with the broker-dealer were used in the business of the broker-dealer, such funds were exposed to considerable risk of loss.

As indicated in this report[87] significant steps have been taken to strengthen the capital structure of the securities industry. The NYSE has revised its net capital rule in six categories: greater haircuts, penalties for short stock record difference, stronger net capital ratios, a $100,000 minimum net capital requirement of its members, provisions providing for more permanent capital and limitations on the temporary infusion of capital. Likewise, as described earlier, the Com-

[86] Naturally, action taken by the Commission pursuant to such authority would be accompanied by appropriate notice and opportunity for hearing to the interested parties.

[87] A detailed description of steps taken by the Commission and the industry to improve the capital structure of the securities industry may be found in the preceding section entitled "Corrective Action Taken By and at the Insistance of the Commission under Securities Investors Protection Act of 1970 and Other Existing Laws."

mission is moving to restrict the use of customer funds and securities, to improve the financial posture of broker-dealers through a quarterly box count requirement and a mandatory buy-in requirement as to customer securities not properly reduced to possession on a timely basis, to increase minimum capital requirements for new entrants into the securities business and to require better financial reporting to customers by the broker-dealer of his financial condition. Finally, broker-dealers, themselves aware of the peril of operating on a heavy debt structure and customers' cash deposits, have taken steps to improve their capital structure. The recent public offerings by broker-dealers of their own securities to secure equity capital and to terminate subordinated borrowings are good examples of this.

This report has indicated the need for refinement and development of regulations to strengthen the financial condition of broker-dealers. In particular we will continue to review the form and substance of the net capital test with a view to arriving at a standard net capital rule applicable to all registered broker-dealers with appropriate exceptions, which rule could be augmented by the self-regulatory organizations to meet their special needs.

The NYSE has a rule establishing a debt to equity ratio. The Commission contemplates a requirement in its own financial responsibility rules to be applicable whether the broker-dealer is formed as a sole proprietorship, partnership or corporation.

5. Need for increased protection for customers' funds and securities

During the 1967–70 period of severe operational and financial problems, many firms, primarily because of inadequate and inefficient recordkeeping and segregation systems and procedures, and the infrequent counting of securities in their possession, mishandled and misused customers' funds and securities. Customers' securities were over-hypothecated and commingled and not properly segregated. Some firms failed to buy in short stock record differences for which a liability existed. Firms used customers' free credit and other credit balances in their daily activities.

The completion of many transactions through the delivery of securities or payment of funds became a matter of weeks rather than days. Not only were customers and other institutions inconvenienced by the inefficiencies and inaccuracies caused by these operational problems, but customers' funds and securities were put in danger of loss at those firms which had lost operational control. Further, as firms began to feel the impact of the "Bear Market" of 1969–70, many firms which lacked sufficient capital began to utilize, properly or otherwise, customers' funds and securities to provide financing for their continued operation. In such situations, customers' funds and securities which then were not protected by the SIPC Act were in immediate danger of loss if the firm, as more than one hundred did, should fail.

As hereinbefore discussed, the Commission has adopted or has proposed to adopt rules designed to provide increased protection for the funds and securities of customers. These rules include provisions which provide for:

(*a*) Restrictions on the use of customers' free credit and other credit balances in the possession of the broker-dealer as well as funds received by the broker-dealer from lending or hypothecating customers' securities;

(*b*) The requirement that customers' fully-paid and excess margin securities be reduced to the possession or control of the broker-dealer;

(*c*) Restrictions on the lending of customers' securities by broker-dealers;

(*d*) Mandatory recordation and buying in of short stock record differences by broker-dealers;

(*e*) Quarterly box counts of securities in the possession of broker-dealers;

(*f*) Periodic reporting to customers by broker-dealers of their current financial and operational condition as well as any other significantly pertinent information; and

(*g*) Prompt notification to the Commission and to the appropriate self-regulatory organizations by firms which are in imminent danger of or are undergoing financial or operational difficulties.

Additionally, the Commission has undertaken an expansion of its broker-dealer inspection programs in order to facilitate the discharge of its oversight responsibilities, particularly in the financial and operational areas.

While the aforementioned rules are fairly comprehensive, the Commission nonetheless realizes that it must continually review all measures taken in the financial and operational area in order to assure the maximum possible protection of public investors. Accordingly, the Commission will, through its own expanded inspection programs and through oversight of the regulatory and supervisory programs of the self-regulatory organizations, maintain a close and continuous review of the implementation and compliance with these rules in the financial and operational area to assure that they are accomplishing their objective of public investor protection.

6. Measures to curtail thefts of securities

The ultimate resolution to the problem of the theft of securities appears to lie in the immobilization or elimination of the stock certificate. However, over the shorter term it appears steps aimed at improved physical control over securities and more accurate and up-to-date records of their ownership and location will go far to improve conditions in this area. It is clear that the absence of such controls has in the past made it easier to accomplish the theft and more difficult to determine promptly that a theft has in fact taken place.

At the present time there is a lack of information as to the securities which have been stolen. For fear of loss of insurance coverage and for other reasons, firms are often reluctant to report the disappearance to the police or other regulatory authorities. On the other hand, brokers, banks and others may purchase securities or accept them as collateral without realizing that they are stolen, even when the theft has been reported. This is due in part to the lack of a readily accessible list of stolen securities and in part to an apparent reluctance of firms and banks to use the services providing such information, because of fear of destroying the bona fide purchaser defense. The Commission believes that one of the measures which should be taken in this area is to require the reporting of all thefts or other unexplained disappearances of securities. A complete list of all securities reported as stolen should be made available to the banking, insurance and securities industries, whether through the National Crime Information Center, "Sci-Tek" (a private company which currently offers lists of stolen securities), or some other organization.

7. Improvement of auditing standards

As previously noted, the 1956 audit guide prepared by the AICPA for audits of brokers and dealers is currently under revision. The Commission intends to follow developments in this area very closely in order to be assured that the accounting problems which appeared in the 1967–70 period will be properly covered in such areas as the treatment of short stock record differences, non-current receivables and the treatment of restricted securities in proprietary accounts. Depending on the nature of the new AICPA audit guide, the Commission may consider the desirability of a release spelling out in detail the auditor's responsibilities with respect to the examination of the broker's operational condition.

Furthermore, the Commission is considering steps to assure itself that required opinions and letters be timely filed. The material inadequacy letters, required under the 1967 amendments to Form X–17A–5, has proven to be a very valuable tool to the Commission in determining the status of broker-dealers but its usefulness has been limited in some instances because of delays in filing. It may be that it will be necessary to clarify the present requirement to state more specifically that the report must be filed at the time of the submission of the Form X–17A–5, or if the firm is unable to do so, that it must seek an appropriate extension of time, disclosing in full the reasons why additional time is required.

Another matter under consideration is the timing of the audit to determine whether changes in this area are appropriate. One possible solution the Commission is considering is a regular annual audit supplemented by unannounced periodic box counts and unannounced examination of certain critical accounts.

8. Improvement of management practices

It is clear that many brokerage firms have not been effectively managed in the past. The problem was particularly critical among large retail firms, where the requirements upon management were the most complex and where the risk to the customer was the greatest. Meaningful management systems were lacking and internal controls were inadequate in both the financial and back office areas. Emphasis on sales activities relegated operational and back office functions to a low priority in prestige and financial commitment, retarding necessary growth and development in these areas. Persons with strong sales records were promoted to managerial positions although they lacked management ability or training. One consequence was the uneconomic expansion of firms, through increases in the number of branch offices and otherwise. Sales operations were expanded and substantial commitments of capital were made without adequate planning and consideration given to such matters as the economic feasibility of the new unit or the back office capacity of the firm to handle the new business which would be generated. Control by the self-regulatory agencies was at best minimal.

Although recent developments in the industry have made firms more aware of the importance of proper management techniques, it is essential that industry groups take steps to prevent future recurrence of the problems. Certain steps have already been taken, but the matters involved are broad and complex, and considerable additional development will be required.

The most critical problem involves firms whose present conditions are such that over the short term continued financial and operational viability may be dependent upon the application of appropriate management techniques. Such a situation requires the direct and individual attention of regulatory and self-regulatory agencies. The Commission's Rule 17a–11 will assist in identifying firms in this position. Beyond that, it should be possible to establish standards, particularly in the area of expansion of business, signalling the approach of potential problems. The NYSE's recent adoption of Rule 326, prohibiting expansion if aggregate indebtedness is more than 1000 percent of net capital and requiring reduction of business if aggregate indebtedness exceeds 1200 percent of net capital, is a step in this direction.

Evidence shows that management problems have not been limited to firms in severe financial or operational difficulty but have been industry-wide. It is clear that many firms could benefit from improved management techniques, and foresight in this area might help prevent repetition of the events of the 1967–70 period. It appears that the self-regulatory agencies could make a substantial contribution, establishing standards and guidelines, assuring themselves that members are developing relevant information on which to make decisions, and otherwise educating and assisting their members. Furthermore, through inspection procedures they should determine that programs for meaningful management systems and effective internal controls are in operation, and as necessary and appropriate, they should pass specific rules to cover these areas. Steps, such as the FACS program, have already been taken in this direction by industry organizations. The Commission will cooperate with various industry groups to further develop systems to improve management capability in the industry.

In connection with the expansion of business, NYSE members for many years have been required to obtain the consent of the Exchange before undertaking major expansion. Before opening a new office, the member had to furnish certain material relating to financial and operational capacity, management and main office supervision, as well as other matters. While there is much merit to this approach, it is clear from the experience of 1967–70 that more effective administration of the rule would be helpful in providing for better protection for the firms' customers. The emphasis here would be not on directly preventing imprudent expansion of firms not meeting certain financial standards, but on a program of actively working with any firms proposing major expansion to ensure that the relevant factors have been considered by management in coming to a decision to undertake such activity.

Finally, in conjunction with the development of improved systems of management, steps should be taken to assure that persons responsible for the implementation of those systems have the necessary background and capability to do so. The self-regulatory agencies have recently announced the formation of an industry-wide task force to deal with qualifications of and training standards for securities industry personnel at various levels of operations. The Commission anticipates that the work of this group will provide suggestions for further improvement of the system.

9. Changes in entry standards

The statutory scheme governing Federal registration of brokers and dealers is premised on a concept of relatively free entry into the securities business, with only minimal capital requirements and rudimentary standards of professional competency. Recent proposals by the Commission to increase the capital requirements and to insure that adequate arrangements have been made with respect to personnel, facilities and financing, described earlier in this report, are steps toward increasing entry standards for brokers. While the Commission has proposed no new standards with respect to professional competency, the Commission's Office of Policy Research is currently engaged in an analysis of the characteristics of firms entering the securities business which will serve as the basis for a review of broker-dealer registration and deregistration requirements. If this study illustrates that newly formed broker-dealers engage in those types of business in which significant amounts of customers' funds and securities are at risk, it may be necessary in the public interest to impose additional entry standards, at least on those broker-dealers proposing to engage in these types of activities. Furthermore, the work of the securities industry task force, described at the close of the previous section, should also yield beneficial results in upgrading the quality of new firms.

10. Improved disclosure to investors of broker-dealers' financial and operational condition

Customers of most brokerage firms were given little information as to the financial and operational condition of the firms to which they entrusted their funds and securities, even though generally monies and securities left with the firm would be at risk in the case of serious financial difficulty. Broker-dealers in most cases preferred to hold information of this type closely, while regulatory and self-regulatory agencies required little or no information to be furnished to customers. The recently proposed amendments to Rule 17a–5 under the Exchange Act [88] represent the Commission's response to this problem and would appear to go a long way toward providing meaningful information to customers. After the Commission has made a careful review of the comments submitted in connection with the above proposal, it will, if warranted, adopt the rules, with any modifications deemed appropriate.

Self-regulatory bodies in the past often had information in their possession, but not made available to the public, indicating that members were in violation of the agency's capital or financial protection rules or that they were materially deficient in meeting segregation or record keeping requirements. On some occasions, disciplinary actions taken against members by self-regulators were not disclosed. The Com-

[88] Exchange Act release No. 9404, Dec. 3, 1971.

mission's adoption of Rule 17a-11 alleviates this problem in part. However, the exchanges and NASD should adopt a program ensuring full and prompt disclosure of all disciplinary action relating to members' financial and operational condition. One suggestion is if the self-regulatory body determines that a member is falling below minimum standards, it formally notify the member of the violation, directing prompt corrective measures. If compliance is not obtained within some prescribed period, the agency's adverse findings should be disclosed to the public, and further prompt remedial action taken. Exemptions would be permitted in only limited circumstances where a specific finding was made that the public interest required a delay in making such information public.

CHAPTER II—NATURE AND USE OF BROKER-DEALER CAPITAL

INTRODUCTION

Recent financial problems in the securities industry, which resulted in the insolvency of a number of firms, raise questions concerning the capital structure of broker-dealers and the adequacy of financial responsibility requirements imposed upon broker-dealers. It became apparent during the stock market decline of 1969 and early 1970 that there were basic weaknesses in the capital structure of firms which contributed to the financial problems of the securities industry during this period. The capital of some broker-dealers was too meager, impermanent in nature, and, in many instances, included securities contributions that declined in value under adverse market conditions and were not actually used for working capital purposes.

The principal method by which the regulatory bodies have attempted to protect investors with regard to the financial responsibilities of broker-dealers has been the maintenance of an adequate net capital base relative to the firms' aggregate indebtedness to assure that firms have sufficient liquid assets to cover their current indebtedness.[1] Until recently, relatively little has been done, however, to regulate the nature and quantity of capital in the form of long-term funded debt or of equity resources invested for the life of the enterprise.

In view of the recent crisis in the securities industry, the goals of this chapter are: (1) to analyze the capital structure of broker-dealers to determine the composition and variation in the capital structure among firms and the extent to which broker-dealers rely on subordinated borrowings and securities contributed as capital; and (2) to demonstrate how the compositions of the capital structure of specific broker-dealers made them incapable of absorbing the financial impact of the crisis from 1968–70.

FINANCIAL DATA EMPLOYED

There are five sources of financial information on securities firms which were utilized for this chapter of the report. These are: (1) the New York Stock Exchange "I & E" reports (1965–1970),[2] (2) financial data filed by the NYSE "monitored" firms (October 1969-December

[1] In addition to the net capital requirements, other provisions of pertinent statutes and regulations, as well as the rules of the various self-regulatory agencies regarding the hypothecation and segregation of securities are designed to protect investors from the misuse of customers' funds and securities in the possession of broker-dealers. See, e.g., the hypothecation provisions of Section 8(c) of the Exchange Act and Rules 8c-1 and 15c2-1 under the Exchange Act, and see NYSE rule 402.

[2] This refers to the income and expense reports filed annually with the NYSE by its members as required by NYSE rule 425.

1970),[3] (3) the Form X–17A–10 reports filed with the NASD for year end 1969 and 1970 (income and expense, summary balance sheet and related information), (4) the Commission's Form X–17A–5 financial questionnaire and (5) other documents in the Commission's files obtained from broker-dealers and the NYSE. In the analysis which follows, primary emphasis is placed on member firms because these include the largest firms in the industry, doing a substantial portion of the public business, and it is for these firms that more complete information is available and has been in computerized form for a number of years. Thus, for example, balance sheet and capital funds data are available for NYSE member firms carrying public customer accounts for the 1965–70 period. In addition, for NYSE "monitored" firms, similar balance sheet information is available for year end 1970 as well as monthly computations of net capital and aggregate indebtedness for October, 1969 through December, 1970. In contrast, the X–17A–10 income and expense reports filed with the NASD (also on magnetic tape) were not required prior to 1969. The Form X–17A–5 reports, which contain a statement of financial condition and information bearing on compliance with the Commission's net capital requirements by broker-dealers required to comply with Rule 15c3–1, are not available on computer tape and therefore are utilized primarily in dealing with individual broker-dealers on a case by case basis.

1. NYSE member firms' general financial position for 1968–1970

Before turning to an analysis of the capital structure of broker-dealers, it may be useful to discuss their overall financial position in recent years. Table 1 contains the aggregate dollar values for the major items of assets, liabilities and capital at year end 1968, 1969 and 1970 for NYSE member firms carrying public customer accounts, as well as ratios which show the relative importance of each of these individual items to the balance sheet as a whole,[4] while Table 2 [5] presents similar information for NYSE monitored firms for year end 1970. As shown in Table 1, between year end 1968 and 1969 total assets for all NYSE member firms carrying public customer accounts declined 29 percent—from \$27.0 billion to \$19.2 billion and between year end 1969 and 1970 the decline was 3 percent—from \$19.2 billion to \$18.6 billion. Capital and subordinated accounts, which totaled \$3.4 billion at year end 1969, declined 16 percent from the 1968 year end and totaled \$3.1 billion at year end 1970, a decline of 9 percent from the prior year.

A. Customers' security account balances

Debit balances in customers' security accounts [6] aggregated \$7.8 billion and accounted for 41 percent of NYSE member firms' total

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[3] The "monitored" firms include a number of NYSE member firms designated by that exchange to report to it in prescribed form on the impact of the interim service charge authorized by the Commission on April 6, 1970. The number of these firms and a list of their names are set forth, at table 2A, *infra*, at p. 52.

[4] Table 16 contains a more detailed balance sheet for NYSE member firms filing such reports at year-ends 1965–70. Because the balance sheet was not made mandatory until 1968, such firms did not file this report for earlier years.

[5] Table 2 appears at p. 52.

[6] These represent the amounts owed by customers to broker-dealers.

assets at year end 1969 while, at year end 1970, this figure was $6.6 billion, 36 percent of NYSE member firms' total assets. Such receivables from customers apply to all debit balances whether in cash or margin accounts. Payables to customers amounted to $4.8 billion at year end 1969 of which $2.8 billion consisted of free credit balances for which customers have an immediate and unrestricted right of withdrawal; [7] and, for year end 1970, payables to customers amounted to $3.7 billion of which $2.0 billion were free credit balances. Cash and deposits available to firms totaled $1.0 billion at year end 1969, about 6 percent of total assets employed, and $752 million at year end 1970, 4 percent of total assets. While free credit balances in customers' security accounts declined 24.4 percent between year-end 1968 and 1969 for all NYSE member firms, cash immediately available to meet the potential demands of customers for these deposits declined only 5.7 percent. Thus, at the end of 1969, NYSE member firms in the aggregate had a larger cash base relative to total liabilities and relative to free credit balances in customers' security accounts than they had at year end 1968. However, free credit balances of customers declined 26.4 percent between year end 1969 and 1970 for all NYSE member firms and cash on deposit to meet the demands of customers for their free credit balances declined 28.2 percent. This evidences an erosion of immediate assets available to fulfill payment of customers withdrawals of their free credit balances.

TABLE 1.—SUMMARY BALANCE SHEET STATEMENT FOR ALL NYSE MEMBER FIRMS CARRYING PUBLIC CUSTOMERS ACCOUNTS (YEAR END 1968-70)

	1968 (millions)	Percent	1969 (millions)	Percent	1970 (millions)	Percent
Assets:						
Cash	$1,110	4.1	$1,047	5.5	$752	4.0
Securities borrowed	1,689	6.2	977	5.1	791	4.3
Securities failed to deliver	4,463	16.5	1,917	10.0	1,447	7.8
Debit balances in customers' securities accounts	11,038	40.9	7,776	40.5	6,595	35.5
Long positions in securities and commodities	6,598	24.4	5,663	29.5	7,412	39.9
Securities exchange membership	447	1.7	277	1.4	187	1.0
All other assets	1,675	6.2	1,539	8.0	1,386	7.5
Total assets	27,020	100.0	19,196	100.0	18,570	100.0
Number of firms	385		379		333	
Liabilities:						
Money borrowed	6,729	24.9	5,429	28.3	7,085	38.2
Securities loaned	1,751	6.5	1,063	5.5	839	4.5
Securities failed to receive	4,739	17.5	2,148	11.2	1,704	9.2
Credit balances in customers' securities accounts:						
(1) Free credit balances	3,636	13.5	2,758	14.4	2,029	10.9
(2) Other credit balances	2,926	10.8	2,080	10.8	1,689	9.1
Short positions in securities and commodities	1,212	4.5	743	3.9	583	3.1
All other liabilities	2,061	7.6	1,624	8.5	1,580	8.5
Total liabilities	23,054	85.3	15,845	82.5	15,509	83.5
Subordinated accounts	1,513	5.6	1,313	6.8	1,145	6.2
Equity capital	2,453	9.1	2,038	10.6	1,916	10.3
Total liabilities and capital	27,020	100.0	19,196	100.0	18,570	100.0

[7] Free credit balances generally arise when a customer gives cash to a broker-dealer to hold, pending receipt of instruction to purchase securities; or when fully paid securities are sold and the proceeds are held pending further investment or further instructions from the customer; or from interest or dividends on the customers securities being held by the broker-dealer.

TABLE 2.—SUMMARY BALANCE SHEET STATEMENT FOR 68 NYSE MONITORED FIRMS (YEAR END 1969-70)

	1969 (millions)	Percent	1970 (millions)	Percent
Assets:				
Cash	$532	4.4	$409	3.0
Securities borrowed	599	4.9	496	3.7
Securities failed to deliver	930	7.7	778	5.7
Debit balances in customers' securities accounts	5,172	42.6	4,934	36.3
Long positions in securities and commodities	4,019	33.1	6,084	44.8
Securities exchange membership	99	.8	72	.5
All other assets	788	6.5	815	6.0
Total assets	12,139	100.0	13,588	100.0
Number of firms	68		68	
Liabilities:				
Money borrowed	3,799	31.3	5,946	43.8
Securities loaned	741	6.1	671	4.9
Securities failed to receive	1,220	10.1	1,081	7.9
Credit balances in customers' securities accounts:				
(1) Free credit balances	1,725	14.2	1,406	10.3
(2) Other credit balances	1,422	11.7	1,257	9.3
Short positions in securities and commodities	569	4.7	442	3.3
All other liabilities	865	7.1	934	6.9
Total liabilities	10,341	85.2	11,737	86.4
Subordinated accounts	594	4.9	608	4.5
Equity capital	1,204	9.9	1,243	9.1
Total liabilities and capital	12,139	100.0	13,588	100.0

Source: 1970 NYSE I. & E. reports, Office of Policy Research.

TABLE 2A

NYSE-Monitored Firms as of May 5, 1971:

Advest
Bache & Co., Inc.
Baker Weeks & Co.
Bateman Eichler Hill Richards, Inc.
Bear Stearns & Co.
Becker (A.G.) Co., Inc.
Bosworth Sullivan & Co.
Brown Bros. Harriman
Burnham & Co.
Butler Wick Co.
Christopher B.C. & Co.
Clark Dodge & Co., Inc.
Conning & Co.
Cowen & Co.
Crowell Weedon & Co.
Daly & Co., Inc.
Davis Skaggs
Dominick & Dominick, Inc.
Donaldson Lufkin & Jenrette
Drexel Harriman Ripley
DuPont Glore Forgan
Eastman Dillion Union Sec.
Edwards (A.G.) Sons
Edwards & Hanly
Elkins Morris Stroud
Fahnestock & Co.
Faulker Dawkins & Sullivan
First Mid America
Foster Marshall
Goldman Sachs & Co.
Halle and Stieglitz
Harris Upham & Co., Inc.
Heine & Co.
Hentz
Hornblower & Weeks
Horward Weil Labouisse
Hummer, Wayne
Hutton (E.F.) & Co., Inc.
Hutton (W.E.)
Illinois Co., Inc.
J.C. Bradford & Co.
Josephthal & Co.
Kidder Peabody & Co.
Kuhn Loeb & Co.
Lawrence Cyrus Sons
Lehman Bros.
Lipper Arthur Corp.
Loeb Rhoades
McCarley & Co., Inc.
Merrill Lynch
Mitchum Jones & Templeton
Neuberger Berman
Oppenheimer & Co.
Paine Webber Jackson & Curtis
Pershing & Co.
Rauscher Pierce Reynolds & Co.
Rothschild & Co.
Rothschild (L.F.) & Co.
Rowles Winston & Co.
Salomon Bros. & Hutzler
Scheinman Hochstin Trotta
Schweickart & Co.
Seligman (J. W.) & Co.
Shearson Hammill & Co.
Shields & Co.
Shuman Agnew & Co.
Smith Barney & Co., Inc.
Sutro & Co.
Thomson McKinnon
Wainwright (H.C.) Co., Inc.
Walston & Co., Inc.
Weis Voisin Cannon
Wertheim & Co.
White Weld & Co.
Witter (Dean) Co., Inc.

B. Proprietary positions in securities and commodities

As shown in Table 1, long positions in securities and commodities declined from $6.6 billion in 1968 to $5.7 at year end 1969, but increased substantially at year end 1970 to $7.4 billion. The relative importance of proprietary positions to total assets increased from 24.4 percent in 1968 to 29.5 percent in 1969 and 39.9 percent in 1970. Long positions in securities and commodities primarily consist of the market value of securities and commodities carried for the firms trading and investment accounts but they also include securities contributed for capital purposes by partners and subordinated lenders. Short positions in securities and commodities totaled $743 million year end 1969 and $583 million at year end 1970.

C. Money borrowed

Money borrowed used to finance customer and firm security accounts transactions totaled $6.7 billion at the end of 1968 and decreased to $5.4 billion in 1969 and yet, money borrowed as a percentage of total liabilities increased from 24.9 percent in 1968 to 28.3 percent in 1969. A substantial increase in money borrowed at year end 1970 to $7.1 billion further increased the percentage of money borrowed to total liabilities to $38.2 percent. Only amounts borrowed related to securities transactions are included in this account; thus, money borrowed which is collateralized by fixed assets or other assets not related to the securities business is not included. Of the $5.4 billion in money borrowed at year-end 1969, slightly more than half was secured by collateral owed by the firm, partners and subordinated lenders. Unsecured borrowings accounted for less than one percent of the total.

D. Securities failed to deliver and securities failed to receive

During the 1968–70 period, a pronounced change in the balance sheet of NYSE member firms occurred in the "fail" accounts reflecting improvements in back office conditions. The securities failed to deliver account, on the asset side shows the amount receivable from sales for which the firm is unable to make delievery to the buying broker at the specified clearance date. Securities failed to receive indicates the amount payable for purchased securities which have not been delivered by the selling broker at the settlement date. Securities failed to deliver decreased from a record $4.5 billion at year end 1968 to $1.9 billion at the end of 1969 and $1.4 billion at year end 1970. This represents a decline to 7.8 percent of total assets at year end 1970 from 10 percent at the end of 1969 and 16.5 percent at the end of 1968.[8]

E. Securities borrowed and securities loaned

Securities borrowed and securities loaned each amounted to about $1 billion for NYSE member firms at year end 1969—and $800 million at year end 1970—a substantial decline from the preceding year's total for each. If a broker-dealer is not able to make timely delivery of

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[8] In the aggregate, all fails to receive of all broker-dealers must, by definition equal all fails to deliver. However, this is not necessarily the case with individual brokers. The imbalance of "fails" mentioned in the text relates only to NYSE members. If the excess of fails to receive over fails to deliver is accounted for by customer purchases, as distinguished from firm trading, the broker has the use of the payment made on settlement date by the customer until the broker on the other side delivers the security. However, under proposed Rule 15c3–4, a broker-dealer would have to set up a cash or cash equivalent reserve, and ultimately buy-in the other broker in connection with aged fails. See Exchange Act Release No. 9388, pp. 3–5.

securities, he may borrow the securities from another broker-dealer against the pledge of a cash deposit at the current market value of the securities. During the period of the loan, the deposit is increased or decreased whenever the market value of the securities changes sufficiently for either party to request an adjustment. Since the cash deposit is interest free, the loan of securities to other brokers can provide an important source of financing to the lending broker while the borrowing broker must forego the use of funds that are deposited with the lending broker that could be profitably employed in his business.

F. NYSE monitored firms 1969–70

In addition to the foregoing data that include all NYSE member firms carrying public customer accounts during the 1968–69 period, more recent financial data for the firms listed on Table 2A (the NYSE "monitored" firms), have been also compiled. Table 2 contains the major items of assets, liabilities and capital for 68 NYSE monitored firms [9] filing statements of financial condition for year end 1970 with the NYSE. For comparison purposes, this table also includes similar information compiled from year end 1969 I & E reports for those firms who filed "monitored" reports at year end 1970. As is evident from Table 2, the assets of 68 NYSE-monitored firms increased from $12.1 billion at year end 1969 to $13.6 billion at the end of 1970. Capital and subordinated accounts totaled $1.9 billion for these firms at year end 1970—almost identical with the end of the previous year—while total assets increased by 11 percent. Important changes in the balance sheet of these firms during this period occurred in the money borrowed account and the firms' trading and investment accounts. Whereas every other major asset and liability item decreased from year end 1969 to 1970, long positions and money borrowed each rose $2.1 billion. The substantial increase in money borrowed was at least in part apparently used to finance the increase in long positions in securities and commodities in the firms' proprietary accounts.

2. Temporary nature of capital

Recent financial problems in the securities industry, including numerous broker-dealer insolvencies, brought to light weaknesses in the capital structure of some firms which contributed to these difficulties. There has been considerable discussion and reference to specific instances revealing that an industry-wide weak capital structure contributed to operational problems during the period of adverse market conditions that prevailed in 1969 and early 1970. The following discussion shows the extent to which the capital base of broker-dealers consists of borrowings under various types of subordination agreements, securities contributed as capital, and the extent to which broker-dealers are financed by current and short-term liabilities as opposed to equity. It will also point out how, even equity contributions are as impermanent in many instances as the proceeds of subordinated borrowings. Although a discussion of net capital rules and related regula-

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[9] Altogether, there were 76 firms in the NYSE Monitored Survey; however, only 68 firms provided balance sheet information.

tory safeguards is deferred to other parts of this report,[10] it should be noted at the outset that protections provided by net capital requirements with a liquidity focus for meeting current obligations are not a substitute for the need for having sufficient long-term capital, in the absence of which the underlying structure of broker-dealers may be unsatisfactory.

Broker-dealer capital consists of the firms' net worth or equity plus various types of subordinated borrowings of cash and securities for capital purposes. Equity in the incorporated broker-dealer normally consists of capital stock, capital surplus, and retained earnings. In addition the appreciation or depreciation in the market value of exchange memberships, represents accretions or diminutions in the equity of the enterprise. Equity in the partnership, on the other hand, is reflected in the capital accounts of general and limited partners and the appreciation or depreciation in the market value of exchange memberships. Included in the debt capital of broker-dealers are the following loan arrangements: Subordinated loans and accounts, secured demand notes, and the accounts of partners subject to equity or subordination agreements. The Commission's Rule 15c 3-1, NYSE Rule 325, and similar rules of the other stock exchanges contain provisions determining the general criterion that must be met for such subordinated borrowings to be considered as a part of the broker-dealer's capital in determining net capital. To the extent that such subordinated capital consists of securities, they are subject to the various "haircut" requirements in determining their actual value in the net capital computation.[11]

Under NYSE Rule 325, all borrowings of cash or securities, regardless of size or description are to be reported to the Exchange, if the proceeds of the loan are intended to be counted as a part of the firm's capital. The Exchange, as a matter of policy, requires that copies of the documents which evidence such borrowings conform to certain standards and that copies of such loan agreements be filled with the Exchange. The character of the documents varies depending on the relationship of the lender to the borrowing broker, such as, individual, partner, stockholder, and the like. Although, in the past, the Exchange has required capital contributions from borrowings to be of at least six months duration, capital withdrawal in some cases was possible on 90 days' notice.[12] The Exchange has recently revised its rules to lengthen somewhat the periods which must lapse between contributions and withdrawals;[13] and, subject to Internal Revenue clearance,

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[10] See, *Infra*, ch. III and IV; and see, *supra*, ch. I, pp. 15–17, 32–34.

[11] The term "haircut" is the popular term for the percentage deductions from the market values of proprietary securities which operate to reduce net worth in the computations of net capital. This is one of the techniques to achieve full liquidity by taking market fluctuations into account. See Exchange Act release No. 8024, January 18, 1967, p. 10.

[12] See NYSE News Bureau Release July 15, 1971, p. 2 regarding revisions effective Aug. 2, 1971.

[13] *Ibid.* Borrowings of cash or securities by NYSE member firms for capital purposes may be arranged with anyone acceptable to the Board of Governors of the NYSE but they generally have been subject to specified limitations. For subordinated borrowings of cash, the lender may be paid an interest rate not to exceed the rate set from time to time by the Exchange. However, the lender may also share in the profits of the firm "to a reasonable extent" if the lender is associated with the firm as (1) a member of the family of one of the borrowing organization's partners or holders of voting stock; (2) an estate or trust established by or for one of the borrowing firm's employees or employees' pension profit sharing plan; or (3) a limited or non-voting stockholder of the borrowing broker-dealer. NYSE Rule 325.

withdrawals may not be made if the effect is to place the firm in violation of net capital requirements.

Since the business of a broker-dealer is the trading and investing of securities and those persons who contribute capital are known to the broker-dealer in the course of its business, it is perhaps natural that capital contributors would desire to contribute securities rather than cash. In the prevailing subordinated loan arrangements, if the contribution is in the form of securities, a principal of a broker-dealer is able to enjoy the benefits of dividends and interest on the securities as well as profits of the firm and also realize any increase in the value of his securities in addition to the interest paid for the loan. The lure to an outside subordinated lender is the interest on a loan of securities to the broker-dealer above any dividend and interest payments from the issuer of the securities or any increase in the market price of the securities.[14]

In order to make such a loan of securities, the lender's major account must have been with the borrowing broker-dealer for at least two years, unless the lender has not been a customer of any organization for two years.[15] In addition to the above limitations on interest payments and participation in profits by outside contributors, the number of such borrowings by a member of the NYSE are supposed to be reasonable in relation to the size of the firm, and the total dollar amount should not constitute more than 25 percent of the total capital of the borrowing organization. Although the NYSE has often expressed its concern to individual firms that this ratio was being exceeded, nevertheless, as evidenced by Tables 3–6 a substantial number of NYSE member firms have been in violation of this Rule in the 1968–70 period.[16]

Subordinated borrowings by broker-dealers who are not members of the NYSE or other exchanges exempt from the provisions of Rule 15c3–1 of the Commission must comply with standards set forth by rule of the Commission in determining whether subordinated borrowings may be considered a part of the firms' capital base for purposes of determining compliance with the Commission net capital rule. If subordinated borrowings are to be treated in computing the aggregate in-

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[14] *Ibid.* In the case of subordinated borrowings of securities or the subordination of equities in the accounts of partners, stockholders, employees or other persons related to the firm, the lender may be paid an interest rate not exceeding 8 percent and may share in the profits of the firm to a reasonable extent. For all other persons making such loans of securities to the firm, the compensation for the loan or subordination of the lenders' account shall not exceed 4 percent of the value of the securities. However, permission has been granted by the NYSE on occasion to exceed this amount. For instance, the subordinated loan from Electronic Data Systems Corporation (EDS) to F. I. duPont, Glore, Forgan & Co. of $2.8 million on August 4, 1970, provided for 10% interest on the face value of the cash and securities in the subordinated account and, in addition, EDS at its option if the subordinated account was extended beyond 90 days could elect to receive 5 percent interest plus a percentage of duPont's profits. Summary Agreement and Detailed Contract Provisions memoranda supplied to the Commission, December 1970.

[15] It should be noted parenthetically here that, when a broker obtains loans from customers to finance his operation, he may have a conflict of interest, particularly if the contributing customer does not participate in profits in the same manner as other contributors of the same types of capital. Other problems respecting subordinated loans by customers will be discussed at pp. 58–63 *infra*.

[16] NYSE Rule 325. In the absence of direct power to enforce the exchange's rules, the Commission has directed the attention of the exchange to those situations as they come to the Commission's attention.

debtedness and net capital of the firm, they must be subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement."[17] In order to be considered a "satisfactory subordination agreement" a written agreement must be executed by both the broker-dealer and lender, whereby a specified amount of cash or specific securities are loaned to the broker-dealer for a period of not less than one year under conditions which subordinate the right of the lender to receive repayment to the claims of all general creditors of the firm. The agreement must provide that the loan may not be repaid or the agreement terminated or modified if the effect is to put the broker-dealer out of compliance with the "net capital" requirements of the rule, (a standard adopted by NYSE subject to internal revenue clearance); and maturity may not be accelerated by reason of any default in the payment of interest or in any other term or condition. The rule, expressly provides that, for the duration of the agreement, the proceeds of the loan will be used by the broker-dealer as part of his capital and subject to the risks of the business.[18]

TABLE 3.—COMPOSITION OF NYSE MEMBER FIRMS' CAPITAL FUNDS (YEAR END 1968-70)

Equity capital as a percentage of total capital	All firms		
	1968	1969	1970
Less than 9.9	7	24	20
10 to 19.9	15	18	20
20 to 29.9	26	24	20
30 to 39.9	30	43	40
40 to 49.9	44	38	29
50 to 59 9	42	41	41
60 to 69.9	41	35	28
70 to 79.9	45	31	29
80 to 89 9	38	48	34
90 to 99.9	35	24	26
100	62	53	46
Total	385	379	333

Source: NYSE I & E reports, Office of Policy Research.

TABLE 4.—COMPOSITION OF NYSE MEMBER FIRMS' CAPITAL FUNDS (YEAR END 1968-70)

Subordinated loans and accounts as a percentage of total capital	All firms		
	1968	1969	1970
0	193	562	134
0.1 to 9.9	54	44	38
10 to 19.9	49	43	30
20 to 29.9	21	23	25
30 to 39.9	20	33	27
40 to 49.9	21	22	22
50 to 59.9	16	19	19
60 to 69.9	8	13	25
70 and over	3	20	13
Total	385	379	333

Source: NYSE I & E reports, Office of Policy Research.

[17] As defined in subparagraph (c) (7) of rule 15c3-1.
[18] The Commission's rule does not contain provisions expressly limiting the interest rate which may be paid subordinated lenders for subjecting their cash or securities to the risks of the brokerage business.

TABLE 5.—COMPOSITION OF NYSE MEMBER FIRMS' CAPITAL FUNDS (YEAR END 1968-70)

Secured capital demand notes as a percentage of capital	All firms		
	1968	1969	1970
0	348	352	311
0.1 to 9.9	18	7	4
10 to 19.9	4	6	6
20 to 29.9	6	5	3
30 to 39.9	6	4	4
40 to 49.9	1	0	1
50 to 59.9	1	3	3
60 to 69.9	1	1	1
70 and over	0	1	0
Total	385	379	333

Source: NYSE I & E reports, Office of Policy Research.

TABLE 6.—COMPOSITION OF NYSE MEMBER FIRMS' CAPITAL FUNDS (YEAR END 1968-70)

Accounts of partners subject to equity or subordination agreements as a percentage of total capital [1]	All partnerships		
	1968	1969	1970
0	65	60	53
0.1 to 9.9	17	18	15
10 to 19.9	21	27	24
20 to 29.9	29	16	10
30 to 39.9	17	12	9
40 to 49.9	19	17	11
50 to 59.9	18	12	11
60 to 69.9	20	23	14
70 and over	37	38	36
Total	243	223	183

[1] Note. This component of capital is not a part of the capital structure of corporations.

Source: NYSE I & E reports, Office of Policy Research.

A major difference that has until recently existed between the Commission's Rule 15c3-1 and Rule 325 of the NYSE regarding subordinated borrowing arrangements relates to whether a broker-dealer may repay such loans at maturity in event that repayment would reduce the firm's net capital below the required minimum. The Commission's Rule does not allow repayment under such circumstances. Exchange Rule 325, however, permitted repayment even though repayment would result in a violation of the Exchange's net capital rule, provided, however, that following repayment the borrowing organization would have sufficient assets to permit the repayment of all outstanding unsubordinated debt.[19] Thus, an important distinction between equity capital and subordinated debt which became of crucial importance in 1970 was that the subordinated borrowings of exchange members (as well as secured demand notes [20]) proved to be wanting in the basic characteristic of capital, in that, at the termination of the loan period, the subject of the subordinated borrowing could be withdrawn if the loan were not renewed. On numerous occasions in 1970 broker-dealers

[19] Under the August 2, 1971 amendments, however, the Exchange's rule has been revised to conform with the Commission's in this respect.

[20] A secured demand note was one which is made, usually without recourse, and issued to the broker-dealer, and is collateralized by a specified value of securities in the maker's account with the broker-dealer, but which cannot be used or resorted to in the absence of insolvency. By an amendment to NYSE Rule 325.20 on July 15, 1971, the right of withdrawal of a secured demand note is suspended if after giving effect to the withdrawal the member organization's net capital ratio would exceed 1200 per centum or its net capital would fail to meet the minimum requirements.

were confronted with the withdrawal of subordinated capital contributed by both insiders and outsiders of the firm while, at the same time, additional capital was needed to offset losses of capital due to the decline in income and also the decline in the market value of securities in the firm's trading and investment accounts as well as securities contributed as capital.[21] On the other hand, as pointed out, the Commission by rule provides that the terms of a subordination agreement must contain certain language in order to be includable as capital in a net capital computation made pursuant to the Commission's net capital rule. Rule 15c3-1(c)(7) under the Exchange Act provides in pertinent part:

> 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 satisfied all of the following conditions:
>
> * * * * * * *
>
> (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 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.

Broker-dealer members of specified exchanges are exempted from the Commission's net capital requirements by paragraph (b)(2) of Rule 15c3-1; but must comply with the provisions of their exchanges with regard to subordination agreements. In 1970, NYSE Rule 325.20(6) provided that:

> The minimum time basis for a subordinated loan by a member organization shall ordinarily be at least one year, except that (A) in the case of a member firm, if the partnership agreement provides that limited partners may withdraw their capital contributions upon written notice of 90 days or less, and (B) in the case of a member corporation, the Certificate of Incorporation authorizes the redemption of the non-voting stock upon written notice of 90 days or less, provision may be made for payment in full of principal and interest prior to the expiration of the loan 90 days after written demand.[22]

In its application of the "ordinarily" one year provisions, however, the NYSE has interpreted that provision so that loans, in some

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[21] Charles Plohn, Sr., withdrew $1.3 million from Charles Plohn & Co., between October 14, 1969, and May 1, 1970. Testimony of Edward Jaegerman before NYSE on July 20, 1970. In January 1970, Plohn's net capital ratio was 1588 percent (SOQ filed with NYSE) and as of the April 24, 1970, audit the firm had a net capital deficiency. At F. I. duPont, Glore Forgan & Co., $2.7 million of capital was withdrawn by former partners of Hirsch & Co. at the same time the firm was seeking additional financing.

[22] This provision was deleted by the July 1971 amendments to NYSE Rule 325 and replaced by a requirement that the subordinated loan agreements must provide:

> That cash may be contributed to a member organization by means of a cash subordinated loan agreement or a subordinated debenture, with a maturity date at least one year from the date of the subordinated loan or debenture, and with acceleration provisions, if any, which may be exercised on not less than six months' written notice given no sooner than six months from the date of the subordinated loan or debenture, provided that if, after giving effect to payment at maturity date or any accelerated maturity date, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital, or its Net Capital would fail to equal or exceed the minimum dollar amount required by Rule 325(a), the obligation of the member organization to repay the subordinated loan or debenture would be postponed until, after giving effect to such payment, the Aggregate Indebtedness of the member organization would not exceed 1200 per centum of its Net Capital or its Net Capital would equal or exceed the minimum dollar amount required by Rule 325(a). NYSE Rule 325.20(4).

instances were subject to the 90-day withdrawal [23] and, on some occasions on as little as only three days notice.[24] Moreover when member firms began to experience financial difficulty, subordinated lenders exercised their right to immediate repayment. This was accompanied in some cases by withdrawals of contributions by partners.

When the Commission conferred with the Exchange on this subject, it urged the Exchange to take steps to stem this flight of subordinated borrowings and to follow the Commission's rule which prohibits withdrawal of a subordinated loan if the effect is to place the broker-dealer in net capital violation; the Exchange through its counsel asserted that it was helpless. This is reflected in his letter of November 12, 1970 to the Commission's General Counsel:

> '[It] should be recognized that certain major problems are raised in considering any such proposal. For example it was only after several years of intensive effort that the Exchange was able to obtain from the Internal Revenue Service a ruling (published as Internal Revenue Bulletin No. 1968–6, dated February 5, 1968) which recognized, under certain stated conditions, subordinated debentures issued by member corporations as debt instruments rather than equity. Prior to the issuance of that ruling IRS examiners in the field had on numerous occasions taken the position that interest payments by member corporations on their outstanding subordinated debentures were not properly deductible business expenses but were, rather, in the nature of dividends, because the subordinated debentures constituted equity rather than debt. The published ruling was finally obtained after much difficulty. One of the main points emphasized in our arguments that the debentures should properly be considered to constitute debt was the fixed maturity date of the debentures, at which point in time the debentures became repayable and repayment could be legally enforced, absent insolvency, bankruptcy, etc. Whether or not the Internal Revenue Service would continue to consider subordinated debentures of member corporations as debt instruments if in fact the stated maturity date must be postponed indefinitely during the period of a net capital deficiency, is certainly open to serious question, but is one of great significance to member corporations. Undoubtedly it should be resolved before subordinated loan agreements are required to contain a provision prohibiting repayment whenever a net capital deficiency exists.
>
> The impact of such a provision on the ability of member organizations to raise or retain badly needed capital must also be weighed. Traditionally the Exchange has felt that such a provision would make it significantly more difficult for member organizations to borrow on a subordinated basis. Present subordinated loan agreements might not be renewed on maturity. It might as well be argued that member organizations, in these days of high interest rates and low profitability, have enough difficulty in attracting and keeping badly needed capital without making that task more difficult by requiring subordinated loan agreements to contain the clause in question.

This same letter set forth the reasons for the claimed inability to prevent the repayment of subordinated borrowings under their existing agreements:

> In view of these considerations, we sincerely feel that no useful purpose would be served by the letter you described briefly in our phone conversation, i.e., a letter from the Commission or the Staff to the Exchange which, as I understand it, would in effect direct the Exchange, regardless of the provisions of currently effective subordinated loan agreements, to prohibit repayment of those loans on maturity whenever repayment might violate Rule 325. Such a letter, we believe, would be unrealistic, because it would direct the undoable. How can valid, enforceable contracts entered into in good faith with the express approval of the Exchange and at least the acquiescence of the Commission, be retroactively

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[23] Subordinated loan agreements obtained from the NYSE show that subordinated loans at Goodbody & Co. were typically for 90 days and that such loans to Charles Plohn & Co. in 1970, to overcome a net capital violation, were for 90 days.

[24] Subordinated loan agreements of New York Securities Co., members of NYSE.

amended in an essential way without the consent of the contracting parties? Even to attempt to do so would, it seems to us, leave the Exchange in an untenable position. We must live with the present agreements, unless amended. If for the future, it is decided that subordinated capital should be "locked in" whenever the borrower is in violation of the net capital rules, the proper approach to achieve this end would be to require the necessary contractual provision in all future subordinated loan agreements.[25]

Goodbody & Co. offers a case study of how a firm sought to induce subordinated lenders not to demand repayment.

A. Goodbody & Co.

In early 1970 when there were indications that it was in financial difficulties, Goodbody, in the first of two communications to subordinated lenders, on March 19, 1970, asserted that the firm was in sound financial condition:

An article appearing in the Wall Street Journal yesterday, while generally factually correct, may have been misleading to those who are not familiar with the details of how our business operates. While our final February figures are not yet available our losses for the first two months of the year will be in the area of $1,500,000 "guessed at" in the Journal.

In anticipation of the losses that subsequently resulted we made a drive last summer and early fall to reduce expenses in a substantial way and are just completing a second cost reduction campaign. Accumulative savings in the area of $1,000,000 per month have resulted. In addition to this we announced the consolidation of five of our small "satellite" offices with the parent office in the same community. This in no way diminished the gross business we were doing as sales personnel in offices consolidated were retained. Nor does this indicate that Goodbody & Co. is attempting to contract its operations. We are, though, working day and night to improve our profit picture in every way possible and will continue to study any and all ways of achieving our objective.

Our current Firm capital is over $65,000,000, a figure that is comfortably above the Stock Exchange minimum requirements. From time to time, and as our business hopefully expands, further additions to capital will be made.

What we and others in the securities industry need is a relaxation of existing tight money conditions which might mean the end of the bear market, an increase in volume, and a quick approval by the SEC and New York Stock Exchange of an interim increase in commissions, pending a final determination of a new commission schedule. We sincerely believe all three may be closer than it seems today.

We anticipate diminishing losses in March and April by which time we hope to be down to at least a breakeven. The expected interim commission increase would effect a dramatic turn-around from red to black figures.

The second report a little over a month later on April 29 continued to encourage subordinated lenders to stand-fast with the firm:

My partners and I felt that you, our friends, who are furnishing a significant part of our Firm Capital, should receive a copy of the following message that went out to our organization yesterday morning and which was subsequently picked up and reported in the press.

Over the past few months member firms of the NYSE have been the subject of a rash of irresponsible rumors regarding their financial condition.

The fact that a few firms have gone out of business, that the industry's profits have suffered as a result of low volume, and that the general outlook is depressed in the way characteristic of bear market have all been contributing factors to the rumors.

Last week at least 10 firms became the subject of the rumor mill. Goodbody & Co. was one of them. In our particular case, another member firm saw fit to

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[25] The amendments to NYSE Rulv 325 now require that subordination agreements contain language suspending the right of withdrawal of subordinated loans if the effect would be to increase a member organizations net capital ratio over 1200 per centum. Moreover, subject to Internal Revenue clearance the present rule of the NYSE provides that withdrawal may not occur if it will result in a violation by the firm of net capital requirements.

spread these false rumors by publishing a version over its wire system. We understand there has since been a retraction of the rumor, but because of the seriousness of the matter we are considering asking the NYSE to bring charges against the firm. Meanwhile since the issue has been raised, I am taking this opportunity to review the facts regarding Goodbody's financial condition.

We have a record amount of capital of $65 million which, to the best of my knowledge, places us among the top 5 firms in the industry.

We have a capital ratio, conservatively stated, of under 15 to 1.

We're subject to no regulatory restrictions.

We have risen to the level of 3rd largest retail firm in the industry.

We are increasing our share of NYSE volume at a faster rate than our leading competitors.

We are one of the handful of major firms which publish annual earnings figures and thereby subject themselves to the healthy aspects of public review.

My primary regret is that I will be reaching my mandatory retirement age of 65 at yearend rather than entering the securities business with Goodbody & Co. at 25. I believe the needs for what we have to offer are virtually unlimited.

So, don't let present difficulties and baseless rumors lead you to sell this business short. Our firm and the industry have a great future.

However, while the subordinated lenders were thus being encouraged to refrain from demanding payment, insiders were apparently withdrawing their capital.

Net equity of general partners of Goodbody declined from $17,749,354 on December 31, 1969, to 12,564,477 on June 30, 1970. The changes in the actual components were as follows:

	Free credit balances	Securities at market long and short	Net commodity equity	General capital	Contributions to capital exchange membership: Value	Contributions to capital exchange membership: Excess
Dec. 31, 1969	$1,001,607	$4,702,283	$6,908	$7,632,500	$4,358,470	$47,586
June 30, 1970	[1] (1,004,326)	4,448,780	38,047	6,568,500	2,505,570	7,906

[1] Represents excess of debit balances over credit balance.

The effect of the decline on partnership equity would have been even more severe were it not for the addition of 19 new general partners who added $862,000 of net partnership equity.[26]

[26] The following table shows the erosion of Goodbody & Co. capital and subordinated borrowings in 1970 part of which may be attributable to market decline and operating losses:

	Net partnership equity	Special Partners capital contributions	Subordinated borrowings
1969			
Dec. 31	$17,749,354	$3,282,500	$48,902,806
1970			
Jan. 31	17,178,809	3,477,500	51,640,153
Feb. 28	17,365,067	3,422,500	53,602,291
Mar. 31	16,124,557	3,902,500	57,255,826
Apr. 30	15,384,617	3,902,500	55,298,640
May 31	13,140,223	3,792,500	48,088,331
June 30	12,564,477	3,617,500	47,575,394
July 31	11,483,471	3,592,500	46,103,122
Aug. 28	11,790,805	3,492,500	40,279,570
Sept. 30	12,471,211	3,417,500	40,260,597
Oct. 31	11,729,781	4,163,302	33,304,120
Nov. 30	11,125,802	[b] 13,654,500	38,439,365
Dec. 11	[a] 9,401,102	[b] 13,619,500	39,499,026

[a] $1,086,712 of restricted securities were not included which had previously been included.
[b] Reflects infusion of capital by Merrill Lynch.

Note: Monthly financial reports of Goodbody & Co.

This flight of capital in the industry was also exemplified by the experience of F. I. duPont, Glore Forgan & Co.

B. F. I. duPont, Glore Forgan & Co.

This firm had $12.7 million in excess net capital at the end of December, 1970,[27] but the projected capital withdrawals from January through July, 1971 amounted to $24,826,000, exclusive of the $2.7 million contributed by the partners of Hirsch & Co. who upon the merger of their company with duPont in July of 1970, were given the option of withdrawing their contributions prior to December 31, 1970.[28] In addition to those impending withdrawals, Edmund duPont, senior managing partner, gave notice of his intention to withdraw his contribution of $4,580,000 between February and August 1971.[29]

3. Methods employed to counteract flight of capital

Traditionally, brokerage firms raised capital internally. Equity capital in a partnership consists of contributions by general or limited partners and of their individual trading accounts subjected to partners' equity agreements [30] or subordination agreements. A broker-dealer organized as a corporation would confine the sales of its stock to upper management personnel.

The period of 1969–70 created a dual problem for broker-dealers' in the raising of capital. First, the decline in volume of shares traded and of market value of securities caused substantial operating losses. Secondly, the decline in market value of securities caused substantial reductions in the value of securities representing contributions of partners, and in the firm investment and trading accounts as well as those which were in subordinated accounts and the subject of subordinated loans.

To combat this shrinkage, most broker-dealers were able to obtain additional contributions from insiders and a small group of outsiders on a subordinated basis. As an example, one partner of Hornblower & Weeks-Hemphill, Noyes & Co. contributed additional securities to support a sagging capital structure. Other broker-dealers, unable to obtain additional financing from existing capital contributors and subordinated lenders or requiring more capital than those persons could supply, employed various other methods to bolster their financial condition, many of which were measures of desperation. However, before discussing these it might be helpful as background to explain the very important distinction between the kinds of arrangements which actually enlarge the resources of a broker-dealer on the one hand, and those which are effected to achieve compliance with an exchange's net capital rule and to provide additional security for customers and creditors, without making any additional contributions to the working capital or the earning power of the firm. A subordinated account agreement and sale and lease-back arrangements are typical of ar-

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[27] Letter from NYSE to Commission dated January 15, 1971.

[28] Letter from NYSE to Commission dated February 9, 1971.

[29] However, most of the capital contributions of the general partners were, in fact, not withdrawn because the general partners no longer had any equity capital in duPont, once the firm's undistributed losses were apportioned.

[30] A partner's equity agreement is one in which the partner has agreed that the equity in his account carried by the partnership shall constitute partnership property. See e.g. Rule 15c3–1(c)(4) under the Exchange Act. In addition to such internal sources, it has been seen that resort has been had to subordinated loan or subordinated account agreements.

rangements which augment net capital without adding to earning power, because the usual subordinated account agreement provides merely that a minimum specified market value of securities will remain in the account without authorizing the broker-dealer to use any part of it in its operations. Failing in their ability to procure actual working capital resources, a number of firms used subordinated account agreements to bolster net capital.

The significance of the sale and leaseback arrangement may be understood by reference to certain principles of the net capital requirements with the emphasis on liquidity. A firm's furniture and fixtures are deducted from net worth for the purposes of a net capital computation. To obviate this inability to have a substantial asset includable as net capital, a practice developed in the 1969–70 climate under which some broker-dealers would sell their furniture and fixtures to an affiliate, created for that purpose only. The affiliate would pay for the purchase from funds obtained by pledging those assets for a bank loan, and the newly created long-term lease under which the broker-dealer agreed to rent the furniture and fixtures, at rentals providing a sufficient amount to make the payments on the loan, would also be placed with the bank as collateral. Since the only liability under the lease effected on the broker-dealer's books is the accrued, and not the prospective rent, this series of steps form the basis for the fiction that the parent's assets include cash in lieu of the furniture and fixtures and that the parent has no liability for the bank loan. Although this might provide additional temporary liquidity, the asset would disappear and the liability would be reflected on a consolidated basis.

A survey by the NYSE as of December 5, 1969 of 445 member firms indicated that 49 had such leased back affiliates. If the corporate veil were pierced as to the 49, ten of them would not have been able to meet the net capital required under the NYSE rules.[31]

In some cases, moreover, firms in financial difficulties made public offerings of securities in violation of applicable registration requirements of the Securities Act of 1933.

A. Walston & Co.

The activity of Walston & Co., Inc. provides an example of the use of the subordinated account toward the end of 1970. The prospective withdrawal of $9 million in subordinated loans by the firm's employee pension fund at the end of the year foretold that a substantial net capital violation would occur at that time.[32]

To improve its financial condition, Walston engaged in several programs including such steps as the filing of a claim for a Federal income tax refund, due as the result of operational losses occurring in 1970, putting into effect a cost reduction program aimed at curtailing losses, and the solicitation of subordinated accounts from its public customers.

The solicitations began sometime in the middle of August, 1970, and extended into mid-December 1970. Of approximateley 280 customers

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[31] Documents supplied by NYSE at December 1969 meeting with the Commission. The NYSE has undertaken a more recent survey of sale, and lease-back arrangements of member organizations, however, the results have not yet been completed.

[32] The pension funds which are administered by the firm's management had to withdraw their subordinated loans because an insurance company would not renew bonds collateralizing the loans as required under Federal law with respect to subordinated loans made to an employer by its employees' pension plans.

who were solicited aproximately 100 accepted and thus purported to augment the firm's net capital with the inclusion of $2 million in the accounts. After deduction of appropriate haircuts on the value of securities for net capital purposes, the subordinated accounts represented over one-half of Watson's excess net capital in July, 1971.[33]

The Commission instituted an administrative proceeding against the firm and on October 7, 1971, it entered an order upon an offer of settlement from Walston & Co. regarding its solicitation of subordinated accounts from about September 1 to December 28, 1970, from customers who were not then or formerly directors, officers or employees of the firm or members of their immediate families. Walston was censured and agreed to guidelines for any future solicitations of subordinated accounts from such persons and to terminate those subordinated accounts which it had solicited in the period from September 1 to December 28, 1970.[34]

B. Bache & Co.

By procuring a number of additional subordinated accounts, Bache & Co. Incorporated increased the value of securities after "haircut" in subordinated accounts from $1,826,643 on June 30, 1969 to $7,096,659 by July 29, 1971.[35]

As of April 30, 1971, Bache computed its aggregate indebtedness at 1020 percent [36] of net capital including the value of all subordinated accounts in the aggregate amount of $21,923,000. Of all subordinated accounts Bache in its registration statement filed with the Commission on July 29, 1971, indicated that at that date, $7,096,659 was obtained from 45 persons who were "customers and others who are not and were never employees, stockholders, debenture holders or relatives thereof". In *Bache & Co. Incorporated*, Securities Exchange Act Release No. 9266, the Commission found that the subordinated account solicitations involved the offer and sale of securities in the form of investment contracts and evidences of indebtedness in violation of provisions of Section 5 of the Securities Act of 1933.[37]

C. McDonnell & Co.

McDonnell & Co., Inc., provides another example of the sale of securities in violation of registration requirements of the Securities Act of 1933 in an attempt to achieve compliance with net capital requirements. In the case of McDonnell & Co., Inc., the offer involved questionable methods. This occurred at the time of the firm's financial peril in the latter part of 1968 and early part of 1969. McDonnell's annual audit as of October 31, 1968 indicated that with net capital of $3,823,302, the ratio of aggregate indebtedness to net capital, based upon the requirements of Rule 325 of the NYSE, was 3027 percent considerably in excess of the allowable maximum of 2000 percent. Fur-

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[33] Division of Trading and Markets memorandum July 15, 1971.

[34] Exchange Act Release No. 9362.

[35] *Bache & Co. Incorporated*, Registration Statement, on Form S-1 (File No. 2-41299), Pt. II, Item 26. p. II-2.

[36] Under applicable rules of the NYSE at the time, Bache would have been in compliance with net capital requirements if its aggregate indebtedness was as much as 2,000 percent of net capital, and under the forthcoming NYSE rules that would have had to be reduced to 1,500 percent.

[37] In light of those experiences, the Commission has found it desirable to publish a release directing attention to the applicable provisions of the federal securities laws in connection with the public offering of subordinated accounts. See Securities Act release No. 9412.

ther, as of January 30, 1969, the NYSE interpreted McDonnell's capital position as reflecting a ratio of 3825 percent, with net capital of $3,092,000 and aggregate indebtedness of $118,265,000.

The Commission ascertained that, in November 1968, McDonnell had offered to approximately 80 of its so-called "key employees" shares of nonvoting common stock. Of this number, 59, including a group of registered representatives who were neither officers nor in supervisory positions, accepted by purchasing $1,300,000 worth of the stock from November, 1968 through May, 1969. At no time were the purchasers informed of the results of the October, 1968 audit. In the circumstances, the Commission instituted an action in the United States District Court for the Southern District of New York to enjoin T. Murray McDonnell and McDonnell & Co., Inc. from further violations of the registration requirements of the Securities Act of 1933 and the antifraud provisions of the federal securities laws. Both defendants consented to the entry of a permanent injunction without admitting or denying the underlying allegations.

4. Relationships among the components of Capital

In order to gain a perspective of the components of broker-dealer capital, Table 7 contains a detailed schedule showing the dollar amounts of capital employed by NYSE member firms carrying public customer accounts at year-end 1970.[38] Each of the major components of capital are presented in this table for clearing corporations, non-clearing corporations, clearing partnerships and non-clearing partnerships.[39]

TABLE 7.—STATEMENT OF CAPITAL AND SUBORDINATED ACCOUNTS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS, YEAR END 1970

[In millions]

PART I—CORPORATIONS

Capital and subordinated accounts	All firms	Clearing firms	Nonclearing firms
Subordinated loans and accounts	$397.0	$347.1	$49.9
Secured capital demand notes	62.5	61.0	1.5
Appreciation (depreciation) of market value of exchange memberships	(4.1)	(5.4)	1.3
Capital stock outstanding	242.3	218.1	24.2
Capital stock in Treasury	(59.0)	(55.5)	(3.5)
Capital surplus	277.7	239.9	37.8
Retained earnings:			
Appropriated	4.9	4.9	0
Unappropriated	417.3	368.1	49.2
Total capital funds	1,338.6	1,178.2	160.4
Number of firms	150	93	57
Total liabilities (other than subordinated)	7,301.4	6,739.2	562.2
Total assets[1]	8,640.0	7,917.4	722.6

[1] A complete balance sheet for these firms is found in Table 18.
Source: NYSE I & E reports.

[38] See Table 17 for year-end 1969 "Statement of Capital and Subordinated Accounts for NYSE Members Carrying Accounts of Public Customers."

[39] In addition, the Table 18 presents the relevant balance sheet data at year-end 1970 for each group of firms. Clearing firms (either partnerships or corporations) are firms which carry accounts of customers and hold customers' funds and securities. A non-clearing firm acts as a forwarding broker; that is, a broker who forwards the transactions of its customers to a clearing firm for clearing and settlement on a disclosed basis.

PART II—PARTNERSHIPS

Accounts of partners subject to equity or subordination agreements	$487.5	$394.8	$92.7
Subordinated loans and accounts	162.8	157.9	4.9
Secured capital demand notes	36.6	36.0	.6
Appreciation (depreciation) of market value of exchange memberships	18.7	15.5	3.2
Capital accounts:			
General partners	784.3	717.6	66.7
Limited partners	232.5	223.9	8.6
Total capital funds	1,722.4	1,545.7	176.7
Number of firms	183	129	54
Total liabilities (other than subordinated)	8,207.2	7,890.6	316.6
Total assets [1]	9,929.6	9,436.3	493.3

[1] A complete balance sheet for these firms is found in Table 18.

Source: NYSE I & E reports.

At year end 1970, there were 353 partnerships and 219 incorporated NYSE members whereas at year end 1969 there were 398 partnerships and 224 corporations.[40]

At year end 1970, there were 150 NYSE member corporations carrying public customer accounts with total assets of $8.6 billion and 183 partnerships with assets of $9.9 billion. Of the $8.6 billion in total assets employed by NYSE member corporations carrying public customer accounts, 93 clearing firms accounted for 92 percent of total assets, while the 57 nonclearing firms accounted for only 8 percent. Among partnerships, 129 clearing firms had assets of $9.4 billion, or 95 percent of all partnerships' assets and 54 nonclearing partnerships had assets of $493 million, or only 5 percent.

Capital and subordinated accounts combined aggregated $1.3 billion for the 150 corporations and $1.7 billion for the 183 partnerships. Clearing firms (partnerships and corporations combined) had capital and subordinated accounts amounting to $2.7 billion, while the much smaller nonclearing firms had about $337 million in total capital funds. The most important distinction between clearing and nonclearing firms regarding capital employed is that nonclearing firms have more capital and subordinated borrowings relative to total assets than do clearing firms; that is to say, nonclearing firms as a group have a lower debt to asset ratio. Total liabilities (excluding subordinated borrowings) were about 84 percent of total assets for both

[40] See the following table:

Year	Total at yearend	Partnerships	Corporations	Newly admitted during year
1970	572	353	219	29
1969	622	398	224	24
1968	646	443	203	24
1967	647	462	185	30
1966	649	484	165	25
1965	651	499	152	26
1964	656	518	138	21
1963	670	556	114	40
1962	672	573	99	23
1961	681	587	74	22

Source: NYSE Fact Book 1971, at p. 57.

clearing partnerships and clearing corporations compared with 78 percent for nonclearing corporations and 64 percent for nonclearing partnerships.

Thus, nonclearing partnerships are less leveraged than other broker-dealers, apparently due to their small size and the relative importance of their investment in an exchange membership which cannot be counted toward net capital but is part of a firm's assets and probably requires proportionately more equity financing than other assets.

As indicated in Table 7, subordinated borrowings contributed for capital purposes aggregated $460 million, while equity capital [41] totaled $879 million at year end 1970 for 150 NYSE member corporations. Of the $460 million in subordinated borrowings held by corporations, 86 percent was in subordinated loans and 14 percent was in secured capital demand notes. Retained earnings accounted for $422 million of the $879 million in equity capital available to incorporated NYSE members. It should be noted, however, that Merrill Lynch, Pierce, Fenner and Smith, Inc., the largest of the 150 corporations, held over one-half of the $422 million in retained earnings.[42] In contrast, this firm accounted for less than one-third of the total assets employed by these firms. In this connection, it should be noted that the preponderance of broker-dealer corporations are very closely held and except for limited liability they are more akin to unincorporated businesses. Capital surplus and the depreciation of stock exchange memberships aggregated $274 million, while the remaining capital was in common and preferred capital stock.

Turning to a discussion of the overall capital structure of partnerships, it is evident from the data in Table 7 that the 183 NYSE partnerships rely somewhat more heavily on subordinated borrowings for capital purposes than do corporations. Thus, secured capital demand notes, subordinated loans, and accounts of partners subject to equity and subordination agreements totaled $687 million or 40 percent of the total capitalization of partnerships compared with 34 percent of the total capital and subordinated accounts employed by corporations. Accounts of general and limited partners subject to equity or subordination agreements (not included in the capital structure of corporations) accounted for 71 percent of the subordinated capital employed by partnerships. Accounts of partners subject to equity or subordination agreements were a relatively more important component in the overall capital structure of nonclearing partnerships when compared with clearing partnerships, although, of course, the dollar amounts involved were considerably less due to the smaller size of nonclearing firms.

The capital accounts of general and limited partners were valued at $1.0 billion of which 23 percent was in the accounts of limited partners. The appreciation in the value of exchange memberships amounted to $18.7 million for the 183 partnerships.

A. Variation in the capital structure among firms

The aggregate data presented in Table 7 indicate a general similarity in the overall capital position of NYSE member firms grouped

[41] Equity capital is defined as total assets less total liabilities and subordinated borrowings for capital purposes.

[42] Merrill Lynch as of Dec. 25, 1970, had $254,240,000 earned surplus. *Merrill Lynch, Pierce, Fenner & Smith Incorporated,* Registration Statement, File No. 2-40156 at pp. 40-41.

as clearing or nonclearing corporations and clearing or nonclearing partnerships; however, an examination of individual firm data reveals that there is considerable variation in the capital structure of broker-dealers. That is to say, there is a rather wide disparity in the importance of individual components of capital relative to total capital funds employed by particular broker-dealers. Thus, some firms rely heavily on subordinated borrowing as a source of capital, while other broker-dealers do not use such financing and their entire capital base consists of equity. Among broker-dealers that have subordinated borrowings, there is, of course, wide variation among firms regarding the relative importance of the particular type of subordinated capital utilized. The data presented in Tables 3 through 6 and Tables 19 through 21 allow us to analyze such differences in the capital structure of all NYSE members doing a public business in 1969 and 1970.

Between year end 1968 and 1969, total capital funds available to all NYSE members doing a public business declined from $4.0 billion to $3.4 billion and between year end 1969 and 1970 they declined further to $3.1 billion. In each year, almost two-thirds of such financing was in the form of equity while the remaining one-third was in subordinated borrowings for capital purposes. The mix of equity financing relative to total capital funds employed by broker-dealers varies widely on a firm by firm basis as indicated by the frequency distribution in Table 3. Thus, at year end 1970 there were 46 broker-dealers among the 333 NYSE members doing public business whose capital base consisted entirely of equity compared with 53 firms at year end 1969 and 62 firms at year end 1968. At the other end of the spectrum, however, equity capital accounted for less than 30 percent of total capital funds available to 48 firms in 1968 and 66 firms at year end 1969 and 60 firms at year end 1970. The remaining capital funds available to these firms, of course, was in the form of subordinated borrowings. In addition to the information presented in Table 3. Tables 19 and 20 show similar data distinguishing between corporations (clearing and nonclearing) and partnershipss (clearing and nonclearing), while Table 21 groups all firms according to asset size.

The aggregate data presented earlier indicated that NYSE partnerships relied somewhat more heavily on subordinated borrowings as a source of capital funds than do NYSE corporations; however, an analysis of the frequency distributions in Table 19 (Part I) and Table 20 (Part 3) gives a clearer impression of the differences that exist between partnerships and corporations in this regard. These data show that there is greater variation among partnerships in their capital structure and that many partnerships do not rely extensively on subordinated borrowings as a source of capital funds. For example, at year end 1970, 17 percent of the 183 NYSE partnerships did not employ subordinated borrowings, while this was true for 10 percent of the 150 NYSE corporations. At the same time, however, 25 percent of all NYSE partnerships had 70 percent or more of their total capital funds in the form of subordinated borrowings compared with only 9 percent for corporations.

Subordinated loans and accounts increased from $510 million to $548 million and $559 million between year end 1968, 1969 and 1970 while total capital funds available to all NYSE member firms doing a public business actually declined by 16 percent between year end 1968 and 1969 and 9 percent between year end 1969 and 1970.[43] Subordinated loans and accounts therefore assumed a greater importance in the capital structure of NYSE member firms during 1969 and 1970 as suggested by the data in Table 4. For example, subordinated loans accounted for 60 percent or more of the total capital funds available to 38 NYSE member firms at year end 1970 compared with 33 firms in 1969 and 11 firms in 1968. Such borrowings of cash or securities normally account for less than 20 percent of the total capital funds employed by members who utilize this account. Subordinated loans were utilized more heavily by corporations than partnerships, accounting for 50 percent or more of the total capital funds available to 50 corporations compared with 7 partnerships. At year end 1970, 26 percent of NYSE partnerships and 89 percent of NYSE corporations doing a public business utilized this source of borrowings for capital purposes (Table 19–Part II).

Secured demand notes are not a very large component of the capital structure of broker-dealers. Secured demand notes total only $99 million at year end 1970—a decline of $47 million over the previous year.[44] As shown in Table 5, only 7 percent of all NYSE member firms carrying public customer accounts employed such financial arrangements at year end 1970, slightly more than the preceding year. Moreover, nonclearing firms used this method of financing less frequently than clearing firms. There were, however, a number of instances where secured demand notes were an important component of net capital to a particular broker-dealer. There were, for example, three corporations and one partnership which at year end 1970 had secured demand notes in amounts equal to all other components of so-called capital.[45]

Accounts of partners subject to equity or subordination agreements amounting to $862 million at year end 1968 declined to $619 million by year end 1969 and $487 million at year end 1970. More than two-thirds of all partnerships employed this source of financing, about the same proportion as the preceding year (see Table 6). Accounts of partners subject to equity or subordination agreements accounted for 50 percent or more of the total capital funds available to about one-third of all NYSE partnerships in 1968, 1969 and 1970.

B. Securities contributed for capital purposes

The foregoing discussion illustrates the flight of insider contributions from a few firms and the extent of their efforts to replace those resources with subordinated borrowings. Moreover, whatever there was of industry capital was heavily weighted in securities. With the marked shrinkages in securities values which occurred in the 1969–70 period, this type of contribution did not stand the industry in good stead. Of the $3.1 billion in capital and subordinated borrowings employed by all NYSE member firms carrying public customer accounts at year end 1970, about $1.1 billion was in the form of securities. Most of these securities were loaned to broker-dealers under subordinated borrowing arrangements; however, about one-third of this amount was in the capital accounts of general and limited partners. The securities

[43] See Table 16.
[44] *Ibid.*
[45] See Table 19, Part III.

in the capital and subordinated accounts of broker-dealers consist of both debt and equity instruments; unfortunately, a breakdown into these categories is not available on an industry-wide basis. Such information is, of course, available through an inspection of individual broker-dealer X–17A–5 reports.

As pointed out earlier, subordinated loans and accounts aggregated approximately $560 million at year end 1970 for the 200 NYSE members who employed such financial arrangements—about two-thirds of that amount was in the form of marketable securities. At the same time, 133 NYSE partnerships employed $440 million in funds attributable to the accounts of partners subject to equity or subordination agreements of which three-fourths was in marketable securities. In addition, about 30 percent of the $1.0 billion in the capital accounts of partners was in the form of marketable securities. Most of the 200 NYSE member firms' partnership capital accounts did not, however, contain securities positions as evidenced by the data in Table 8. This table contains data which shows the relative importance of marketable securities to total funds available in selected capital and subordinated accounts of NYSE partnerships and corporations at year end 1970.

TABLE 8.—MARKET VALUE OF SECURITIES AS A PERCENTAGE OF TOTAL FUNDS AVAILABLE IN SELECTED CAPITAL AND SUBORDINATED ACCOUNTS OF NYSE MEMBER FIRMS, (YEAR END 1970)

Percent	Subordinated loans and accounts of corporations and partnerships	Accounts of partners subject to equity or subordination agreements	Capital accounts of general and limited partners
0	65	22	170
0 1 to 19 9	6	3	5
20.0 to 39 9	9	6	9
40.0 to 59 9	18	7	4
60.0 to 79 9	31	16	4
80 0 and over	71	79	8
Total	200	133	200

This heavy emphasis on securities as the means for maintaining solvency is illustrated by the experiences of Dempsey-Tegeler & Co., Inc.

Dempsey-Tegeler & Co., Inc.

The annual audit of Dempsey-Tegeler as of 1968 indicated that the $12.7 million attributed to capital was comprised of $4.3 million of equity and $8.3 million of subordinated borrowings. The 1969 audit as of June 1 revealed that the capital item had increased to $30.6 million consisting of subordinated borrowings of $24.9 million and equity of $5.7 million (the latter having almost entirely resulted from an increase in earned surplus from the previous profitable year). Nevertheless Dempsey-Tegeler was in financial difficulty, as shown by a 2169 percent net capital ratio which was computed by the NYSE for the June 1 audit (net capital deficiency $1,126,000) [46] and by December 31 the net capital deficiency was $10,300,000.[47]

[46] Memorandum of Division of Trading and Markets "Dempsey-Tegeler Quick Fact Sheet as of 10/20".
[47] Memorandum of Division of Trading and Markets, Feb. 18, 1970.

In early 1970, the financial situation continued to deteriorate with a cumulative loss from November 1969 through February 1970 of $1.4 million which resulted in a net capital deficiency of $5,660,524.[48] In an effort to improve its capital Dempsey-Tegeler solicited John M. King, Chairman of King Resources, Inc., for a subordinated loan. A relationship existed in that Dempsey-Tegeler had made a public offering of King Resources stock in 1967; and, in 1968, it had underwritten for King Resources a convertible debenture offering. In January, 1970 to shore up Dempsey-Tegeler's deteriorating financial condition, King Resources registered with the Commission 500,000 shares of King Resources owned by John M. King and his family with the purpose of rendering them readily convertible into cash and placing them in a subordinated account at Dempsey-Tegeler. At the time of registration those shares represented approximately $11 million at the current market value. On that basis upon the subordination in March 1970, Dempsey-Tegeler appeared to be out of net capital violation. According to its calculation as of March 31, 1970, it achieved a 1501 percent net capital ratio.[49] The market value of King Resources declined shortly thereafter so that, by April 30, 1970, the market value of the shares in the subordinated account was $5.5 million ($14 per share) and by May 22 the value had further declined to 6¾ causing the securities value of the account to be only $2.7 million. By July, when thought was being given to selling these shares to save the haircut value, prospective underwriters declined to participate and that avenue of improving net capital was forclosed.[50]

Hayden, Stone Inc.

Hayden, Stone's abortive attempt to extricate itself from a financial crisis by the infusion of securities in subordinated accounts demonstrates still further the fraility of over-reliance on securities for such purposes. On March 13, 1970 a group of Oklahoma businessmen agreed to subordinate $14.4 million in net capital value of their own corporation's securities. The contributors were: Bill Swisher, CMI Corp.; Jack L. Clark, Four Seasons Nursing Centers: Jack E. Golsen, LSB Industries; Carousel Fashion, Inc.; and various executives and large shareholders of Woods Corp. A simple chart can best demonstrate the rapid decline of the market value of these securities:

Security	Market value on Mar. 13, 1970		Market value on June 12, 1971	
	Per share	Aggregate	Per share	Aggregate
Four Seasons Nursing Centers of America, Inc. (120,000 shares)	$40.75	$4,890,000		
CMI Corp. (165,000 shares)	26.50	4,372,500	$14.38	$2,373,700
Woods Corp (110,000 shares)	19.25	2,117,500	11.00	1,210,000
LSB Industries, Inc (200,000 shares)	6.00	1,200,000	4.63	926,000
Carousel Fashions, Inc. (280,000 shares)	17.50	4,900,000	16.00	4,480,000
Total value of securities		$17,480,000		$8,988,700

[48] SOQ as of Feb. 27, 1970, filed with NYSE.
[49] SOQ filed with NYSE as of Mar. 31, 1970.
[50] Since common stock is given net capital computation value of only 70 percent of market value, a broker-dealer's net capital can be improved by the sale of such securities at market value for cash.

5. Capital structure of non-members of the New York Stock Exchange

In addition to the financial information that has been available for NYSE members for a number of years, similar year end data has become available for other broker-dealers through the X–17A–10 reports. Tables 9 and 10 summarize such financial information for 761 broker-dealers who filed X–17A–10 reports with the NASD and had gross securities commission income of at least $100,000 during 1970.[51] The combined total assets of these firms aggregated $3.5 billion while their capital and subordinated accounts totaled $860 million. This compares with figures cited above for NYSE members with $18.6 billion in assets and $3.1 billion in capital and subordinated accounts. Included in the NASD capital figure was $122 million in subordinated borrowings; such borrowings accounted for 17 percent of total capital funds employed by these 761 broker-dealers. Of the $122 million in subordinated borrowings utilized by these firms, about 81 percent was in subordinated loans while the remainder was in the accounts of partners subject to equity or subordination agreements.

TABLES 9 AND 10—SELECTED FINANCIAL DATA FOR 761 BROKER-DEALERS FILING X-17A-10 REPORTS WITH THE NASD (YEAR-END 1970)

TABLE 9

[Dollars in thousands]

Assets, liabilities and capital funds	NASD only	All exchanges except NYSE	Total
Total assets	$1,650,768	$1,849,961	$3,500,729
Total liabilities (other than subordinated borrowings)	1,245,592	1,395,513	2,641,105
Total capital and subordinated accounts	405,176	454,448	859,624
Subordinated Accounts	44,230	77,696	121,926
(1) Subordinated loans and accounts	36,572	62,754	99,326
(2) Accounts of partners subject to equity or subordination agreements	7,658	14,942	22,600
(3) Secured capital demand notes	0	0	0
Equity capital	360,946	376,752	737,691
Number of firms	388	373	768

TABLE 10

Subordinated accounts as a percent of total capital	NASD only	All exchanges except NYSE	Total
0	260	176	436
Under 10.0	10	13	23
10.0 to 19.9	9	22	31
20.0 to 29.9	17	23	40
30.0 to 39.9	12	27	39
40.0 to 49.9	9	15	24
50.0 to 59.9	20	20	40
60.0 to 69.9	9	14	23
70.0 to 79.9	7	22	29
80.0 to 89.9	8	10	18
90.0 to 99.9	7	7	14
100.0 percent and over	20,	24	44
Total	388	373	761

Note: These data are based on X-17A-10 reports filed with the NASD by broker-dealers with Securities Commission income of at least $100,000 during 1970; NYSE member firms are not included

[51] The capital funds statements of broker-dealers with securities commission income of less than $100,000 are filed in abbreviated form only and are not included in this discussion. In addition to the information presented in Tables 9 and 10, the Table 24 contains frequency distributions showing the debt-to-asset ratios for these firms.

The data in Tables 9 and 10 are also broken down, distinguishing between broker-dealers who are members of a stock exchange (other than the NYSE) and those NASD members who do not belong to any exchange. The total assets of the 388 broker-dealers not belonging to an organized exchange totaled $1.7 billion. Total capital of these firms was $405 million, of which $44 million was in the form of subordinated borrowings. The 373 exchange members (other than the NYSE) had total assets of $1.8 billion, while their capital and subordinated accounts totaled $454 million, including $78 million in subordinated borrowings. Total debt (including subordinated borrowings averaged about 80 percent of total assets of both "other" exchange members and "NASD only" broker-dealers.

As was the case with NYSE firms, the capital structure of nonmember broker-dealers varied considerably at year end 1970 (see Table 10). There was a greater tendency for these firms to rely on equity as opposed to subordinated borrowings as a source of capital funds when compared with the NYSE members analyzed earlier. Two-thirds of the 388 broker-dealers who did not belong to any stock exchange, and nearly 47 percent of the 373 broker-dealers who belong to "other" exchanges, did not utilize subordinated borrowings as a source of financing. Furthermore, subordinated borrowings accounted for 50 percent or more of the total capital funds employed by only 18 percent of the 388 broker-dealers who did not belong to a stock exchange, compared with 26 percent of the 373 broker-dealers who were members of exchanges other than the NYSE. As noted, earlier, 61 percent of the NYSE member firms had one-half or more of their total capital funds in the form of subordinated debt at year end 1970. It appears that broker-dealers who are not members of a stock exchange, by the general nature and scale of their business, rely less extensively on subordinated borrowings as a source of capital funds than do broker-dealers who are exchange members. Although the value of exchange seats is an asset, under the net capital rules the value is deducted from net capital as not being a liquid asset. Accordingly, non-exchange members do not face the situation of having their net worth adjusted by that item in the computation of net capital.

6. Leverage available to broker-dealers

The overall leverage available to broker-dealers is substantial. At year end 1969, NYSE member firms which carried public customer accounts had only $2.0 billion in equity capital available to finance $19.2 billion in assets, while at year end 1970, NYSE member firms had $1.9 billion in equity capital and $18.6 billion in assets. It should be noted here that equity capital excluded subordinated borrowings, which, if included, would raise the figure to $3.4 billion in 1969 and $3.1 billion in 1970. From the standpoint of the investor and investor protection, subordinated borrowings have too often proven to be tenuous. Moreover from the standpoint of broker-dealers as going concerns, subordinated borrowings cannot properly be considered capital during the period approaching maturity in that subordinated debt is in fact a current liability.

At the end of 1970, total liabilities (including subordinated borrowings) were 90 percent of total assets for NYSE member firms. To a large extent, the tremendous leverage available to many broker-dealers has come from their ability to rely on customers' funds and securities in financing assets. Normally, leverage to the degree that exists in the financial structure of broker-dealers would not be possible if customer funds and securities were not available and these firms had to rely on the usual sources of financing available to other businesses.

Commercial banks—the principal source of business loans—have made few unsecured loans to broker-dealers; and broker-dealers not acting as market makers, specialists, underwriters, or block positioners, are limited by margin requirements on the extent to which they may utilize their principal source of borrowings—namely, loans collateralized by marketable securities. Thus, with customer funds available, some broker-dealers not only have had the free use of funds, but may be relying upon those funds to fill a need for which loan funds from other sources, in some cases, may not be available.[52]

At year end 1969 and 1970, for example, 41 and 33 percent, respectively, of the assets of NYSE member firms doing a public business was financed by payables to customers or money borrowed secured by customers' collateral (see Table 16). Total net credit balances carried for customers aggregated $5.0 billion and $3.9 billion while money borrowed secured by customers' collateral amounted to $2.8 billion and $2.3 billion, respectively, at year end 1969 and 1970.[53] The latter amounts are used primarily to finance the debit balances of margin customers. Included in the payables to customers are free credit balances in customers' securities accounts, to which customers have an immediate and unrestricted right of withdrawal, but which, represented interest-free funds which the firm may use for any business purpose. These free credit balances alone amounted to $2.8 billion at year end 1969 and $2.0 billion at year end 1970 for NYSE member firms and were available to finance 14 percent at year end 1969 and 11 percent at year end 1970 of member firms' assets. In addition to free credit balances, the firm may obtain funds from the loan of customers' margin securities for which the borrower must make a 100 percent cash deposit with the firm. The data do not permit a determination of the amount of free funds generated in this manner but total deposits on account of securities loaned at year end 1969 were $1.1 billion and at year end 1970 were $839 million.

The data presented in Tables 11 and 12 as well as Table 22 are indicative of the leverage available to NYSE member firms of various asset sizes. These data suggest that there is a relationship between the asset size of the broker-dealer and the leverage available to the firm; that is to say, the larger the firm's size in terms of total assets, with subordinated loans of cash or securities.

The data presented in Table 11 show the concentration of assets among NYSE member firms at year end 1970 arranged according to the asset size of the firm, while Table 12 shows the concentration of equity capital for these same broker-dealers grouped in exactly the same manner as in the preceding table. The relationship between the concentration of assets and concentration of equity capital among groups of NYSE member firms is a clear indication of the leverage

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[52] See the discussion of "Use of Customers" Funds and Securities," *infra*, ch. IV.

[53] This figure being "net" gives effect to amounts payable by individual accounts as an offset to amounts payable to them by the broker-dealer.

available to firms of various asset sizes. Thus, for example, at year end 1970 the 13 largest NYSE member firms (each having assets of $250 million or more), accounted for 51.9 percent of the $18.6 billion in assets held by all NYSE members doing a public business but accounted for only 36.7 percent of the $7.9 billion in equity capital. Therefore, the $703 million in equity available to the 13 largest NYSE members supported $9.6 billion in assets and these firms had a combined debt-to-asset ratio of 92.7 percent. The 37 firms (each with assets $100 million or more) had total equity capital of $12 billion at year end 1970 or 61.3 percent of the equity capital held by all NYSE members; however, this same group of firms accounted for 71.3 percent of the total assets of all NYSE members which again indicates the leverage available to the largest NYSE firms doing business with the public.

TABLE 11.—CONCENTRATION OF ASSETS AMONG NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

Member firms' asset size (millions)	Number of firms	Total assets (millions)	Cumulative totals: Number of firms	Cumulative totals: Total assets (millions)	Cumulative totals: Percentage
$250 and over	13	$9,646	13	$ 9,646	51.9
$100 to $249.9	24	3,591	37	13,237	71.3
$50 to $99.9	20	1,317	57	14,554	78.4
$25 to $49.9	54	1,901	111	16,455	88.6
$10 to $24.9	85	1,371	196	17,826	96.0
$5 to $9.9	79	573	275	18,399	99.1
Under $5	58	171	333	18,570	100.0
Total	333	$18,570			

TABLE 12.—CONCENTRATION OF EQUITY CAPITAL AMONG NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

Member firms asset size (millions)	Number of firms	Equity capital[1] (millions)	Cumulative totals: Number of firms	Cumulative totals: Equity capital (millions)	Cumulative totals: Percentage
$250 and over	13	$703	13	$ 703	36.7
$100 to $249.9	24	470	37	1,173	61.2
$50 to $99.9	20	160	57	1,333	69.6
$25 to $49.9	54	246	111	1,579	82.5
$10 to $24.9	85	202	196	1,781	93.0
$5 to $9.9	79	95	275	1,876	98.0
Under $5	58	39	333	1,915	100.0
Total	333	$1,915			

[1] Equity capital is defined as total assets less total liabilities and subordinated borrowings.

Source: NYSE I & E reports, Office of Policy Research.

At the other end of the spectrum, the 137 smallest NYSE members (each with assets of less than $10 million) accounted for only 4.0 percent of the total assets of all firms but 7.0 percent of the equity capital employed by all NYSE members. The 79 firms with assets between $5.0 and $9.9 million had a combined debt-to-assets ratio of 83.4 percent while, for the 58 smallest NYSE members (assets under $5.0 million) doing a public business, total liabilities were only 77.2 percent of total assets.

The data on concentration of equity capital and assets among groups of NYSE members clearly demonstrates that the larger NYSE member firms carrying accounts of public customers had significant amounts of customers' funds or subordinated loans and have the highest leverage while the smallest firms finance a larger proportion of their assets with equity as opposed to liabilities. For each of the groups of firms presented in Tables 11 and 12, Table 22 Part I presents a frequency distribution showing total liabilities (including subordinated borrowings) as a percent of total assets. At year end 1970, for example, 10 of the largest 13 NYSE member firms had total liabilities equal to 90 percent or more of total assets while only six of the 60 smallest NYSE members (assets under $5.0 million) were this highly leveraged. Moreover, of the 24 largest NYSE members at year end 1970 (each with assets of at least $100 million) only three firms had total liabilities that were less than 80 percent of total assets. However, among the 137 smallest NYSE members (assets less than $10 million), 14 percent of these firms had total liabilities that were less than 80 percent of total assets. For purposes of comparison, similar information is presented in Table 22 Parts II through V for year end 1968 and 1969.

Of course, if subordinated borrowings were eliminated from total liabilities in the computation of the firm's debt-asset ratio, the leverage ratios would be reduced. Nevertheless, even with subordinated borrowings for net capital purposes eliminated from total liabilities, the remaining leverage available to broker-dealers is substantial. Table 23 shows total liabilities, other than subordinated borrowings, as a percentage of total assets for NYSE members for 1970 (Part I), 1969 (Part II), and 1968 (Part III). In assessing this data, it should be noted that subordinated borrowings, from the standpoint of the broker-dealer as a going concern, are in fact a current liability during the period approaching maturity. Unfortunately, we do not have information on the maturity dates of such borrowings which would permit a breakdown between current and long-term liabilities.

The data in Table 13 shows the concentration of total capital and subordinated borrowings among groups of NYSE member firms at yearend 1970. This data is comparable to that presented earlier on the concentration of equity capital. For example, the 13 largest firms had $1.0 billion in total capital funds and accounted for 32.9 percent of the $3.1 billion in total capital and subordinated borrowings employed by all NYSE members while the 37 largest firms (each with assets of at least $100 million) had total capital funds of $1.7 billion or 55.1 percent of the total. Liabilities, other than subordinated borrowings, accounted for 87 percent of the $13.2 billion in total assets employed by the 37 largest NYSE members compared with 69 percent of the $36.9 billion in total assets employed by the 137 smallest member firms (each with assets under $10 million).

TABLE 13.—CONCENTRATION OF TOTAL CAPITAL AMONG NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

Member firms asset size (millions)	Number of firms	Total capital [1] (millions)	Cumulative totals: Number of firms	Cumulative totals: Total capital (millions)	Cumulative totals: Percentage
$250 and over	13	$1,006	13	$1,006	32.9
$100 to $249.9	24	679	37	1,685	55.1
$50 to $99.9	20	299	57	1,984	64.9
$25 to $49.9	54	467	111	2,451	80.1
$10 to $24.9	85	383	196	2,834	92.6
$5 to $9.9	79	166	275	3,000	98.0
Under $5	58	61	333	3,061	100.0
Total	333	$3,061			

[1] Total capital includes "capital" plus subordinated accounts.

TABLE 14.—CAPITAL AND SUBORDINATED ACCOUNTS FOR 284 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1965-69)

[In millions of dollars]

Capital and subordinated accounts	1965	1966	1967	1968	1969
Subordinated loans and accounts	166.5	175.3	251.3	415.0	456.8
Accounts covered by equity or subordination agreements	386.6	384.3	568.4	740.3	541.6
Secured capital demand notes	83.2	79.7	103.5	138.8	143.7
Equity capital	1,091.1	1,171.5	1,684.7	2,029.1	1,727.6
Total	1,727.4	1,810.8	2,607.9	3,323.2	2,869.7
Total liabilities (other than subordinated)	7,928.6	8,960.3	13,438.7	19,318.2	13,703.7
Total assets	9,656.0	10,771.1	16,046.6	22,641.4	16,573.4

TABLE 14(A).—CAPITAL AND SUBORDINATED ACCOUNTS FOR 324 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969-70)

[In millions of dollars]

	1969	1970
Capital and subordinated accounts:		
Subordinated loans and accounts	$394.9	$543.3
Accounts covered by equity or subordination agreements	564.9	482.3
Secured capital demand notes	130.7	99.1
Equity capital	1,920.4	1,897.6
Total	3,010.9	3,022.3
Total liabilities (other than subordinated)	14,223.8	15,377.1
Total assets	$17,234.7 (1)	$18,399.4 (1)

[1] 324 firms.

7. *Trends in financial structure*

A. NYSE member firms 1965–70

The availability of continuous financial data over a five-year period for 284 NYSE member firms permits us to analyze the financial structure of these broker-dealers during the 1965–69 period. Table 14 shows the amounts of equity capital, subordinated borrowings, total liabilities and assets employed by these 284 firms during this five-year period.[54] Total assets aggregated $16.6 billion at year end 1969—an

[54] Table 25—Part II contains a frequency distribution for these 284 firms showing total liabilities (including subordinated borrowings) as a percent of total assets while Table 25—Part III shows similar data for total liabilities, other than subordinated borrowings, as a percentage of total assets.

increase of 72 percent during this five-year period while capital and subordinated accounts amounted to $2.9 billion or an increase of 66 percent. These data indicate that a pronounced change in the capital structure of broker-dealers did not occur during this five-year period, although firms did rely somewhat more heavily on subordinated borrowings at year end 1969. For example, 69 firms did not employ any type of subordinated borrowings in 1965 compared with 42 such firms at year end 1969 (See Table 25—Part I). Moreover, except in 1968, when a much larger proportion of the assets of these firms was financed by liabilities as opposed to equity, the leverage available to firms increased only slightly.

Table 14A shows similar data for 1969–70 for 324 NYSE member firms. Total assets for this group of firms increased from $17,234.7 million to $18,399.4 million; an increase of 6 percent; however, equity capital declined slightly from $1,920.4 million to $1,897.6 million. Subordinated loans and accounts, covered by equity or subordinated borrowings and secured demand notes on the other hand, increased from $1,072.5 million to $1,124.7 million, an increase of 5 percent, which indicates that broker-dealers were relying more heavily on nonequity funds.[55]

TABLE 15.—RETURN ON TOTAL CAPITAL FUNDS OF OVERALL BUSINESS BASED ON THE EXPERIENCE OF 6 MONTHS (OCTOBER 1970–MARCH 1971) AT ANNUAL RATE FOR 69 NYSE MONITORED FIRMS VERSUS THAT OF 357 NYSE FIRMS IN 1967 (THE HIGHEST OF THE 5-YEAR PERIOD 1965-69)

[In millions of dollars]

	6 months (October 1970–March 1971	1967
Net operating income before partners' compensation and taxes	$946	$1,058
Imputed partners' compensation at 6 percent of gross revenue	229	234
Net operating income before taxes	717	824
Average capital funds	[1] 1,866	2,560
Percentage of pretax return on capital	38	32

[1] Estimated.

Note: Total capital funds includes equity capital plus subordinated borrowings.

B. Return on Capital: NYSE Monitored Firms

Recent data for the Ocober 1970–March 1971 time period show substantial improvements in the profitability of NYSE monitored firms. As evidenced by the data in Table 15, after an allowance for partners' compensation (assumed to be 6 percent of gross revenue) the annual rate of return on total capital funds employed by 69 monitored firms was 38 percent (before taxes) for the six-month period ending March 31, 1971. In arriving at a return on total capital, for purposes of this computation, we have included subordinated capital at the same rate as pure equity. The resulting estimated rate of return obtained on total capital funds during this period of time exceeded the 32 percent of 1967—the highest rate of the entire 1965–69 period.

[55] See Table 25—IV–VI for frequency distributions based upon data of Table 14A.

CONCLUSION

The need for the adoption of standards concerning the permanency of broker-dealer capital and the undue concentration of it in volatile securities is quite plain indeed.[56]

The setting of adequate capital standards is intimately related to the requirements of the new rules of the Commission on the subject of reserves for credit balances and the protection of securities, as authorized by the amendment of Section 15(c)(3) of the Exchange Act by the SIPC legislation.[57] The extent to which those new requirements provide customer protection should determine the capital structure of the industry.

The New York Stock Exchange has recognized the need for more capital by amending its rules to enable its members to raise permanent equity capital by the public issuance of securities.[58] NYSE member organizations which currently have publicly issued their securities include Bache & Co., Inc.; CBWL-Hayden, Stone, Inc.; Donaldson, Lufkin & Jenrette, Inc.; A. G. Edwards & Sons, Inc.; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Piper, Jaffrey & Hopwood, Inc.; Reynolds Securities, Inc. In conjunction with the Exchange's new approach, the NASD has taken measures to facilitate the public offerings of the securities of its members.[59]

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[56] Mr. Felix G. Rohatyn, General Partner of Lazar & Freres & Co. and Chairman of NYSE Surveillance Committee, commented on this subject in discussing net capital rules: "There are very few businesses—and I think finance companies are about the only businesses that come to mind—that operate on this kind of leverage, so that even if you say that the capital rules have already discounted a lot of the assets that they have thrown out—the furniture, say—and they have is counted [sic., haircutted] the value of securities by 20, 30, or 40 percent, or whatever it is, you still have two factors that still keep too much volatility as far as I am concerned. One, the firms can have capital invested in securities. As long as you have that, my arguments on early warning are premised on the fact that you do not know how to warn early enough that the market is going to go down. I do not know if the market is going to go down, and when you have capital invested in securities you have that kind of danger.

"And also, the only business that I know of where subordinated loans count as capital is this business.

"Now, we do throw out a lot of other assets in terms of capital computation; but a subordinated loan is computed as capital even though it is money you owe after a year or a year and a half; and it seems to me these are probably the two major areas of danger in terms of the structure of these firms: (1) That they are allowed to invest capital in securities and, therefore, speculate, and you have a very high degree of volatility; and (2) that you do not still have enough limitation on subordinated loans and on the kinds of short-term money that is counted as capital." 1971 Subcommittee hearings, pt. 1, p. 36.

[57] See Exchange Act Release 9388, November 8, 1971. For a more detailed discussion of these proposed rules see ch. I, *supra*, p. 30.

[58] The NYSE amended its constitution and rules on March 26, 1970, so as to permit public ownership of member organizations, i.e., sale by member organizations of freely transferable securities. See NYSE Constitution, Art. I, Section 3(h), and Art. IX, Secs. 9 and 11.

[59] Pending proposals for rules on the subject, the NASD withdrew its then existing flat prohibition against "self underwriting," and, in lieu thereof has appraised the distribution arrangements on a case by case basis.

TABLE 16.—COMPARISON OF BALANCE SHEET DATA FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1965–70)

[Dollar amounts in millions]

	1965	1966	1967	1968 [1]	1969	1970
ASSETS						
Cash	$539	$594	$750	$1,110	$1,047	$752
Deposits subject to withdrawal restrictions:						
Securities	16	16	21	89	97	97
Commodities	76	98	92	126	107	104
All other deposits	20	25	55	([2])	([2])	([2])
Securities borrowed	452	476	1,098	1,689	977	791
Securities failed to deliver	905	857	3,383	4,463	1,917	1,447
Receivables from other broker-dealers:						
Securities accounts	107	101	210	355	196	149
Commodities accounts	7	10	10	13	14	12
Total net debit balances carried for customers:						
Securities accounts	5,494	5,460	8,403	11,038	7,776	6,595
Commodities accounts	28	29	51	37	47	20
Net debit balances in general partners' accounts not covered by equity agreements	27	30	26	85	51	51
Long positions in securities and commodities	2,609	3,730	3,887	6,598	5,663	7,412
Secured demand notes	84	81	101	139	147	101
Securities exchange membership	139	152	338	447	277	187
Fixed assets	60	72	107	146	183	202
Other assets	135	170	251	685	697	650
Total assets	10,698	11,903	18,783	27,020	19,196	18,570
Number of firms	345	355	357	385	379	333
LIABILITIES						
Money borrowed	4,337	5,125	5,163	6,729	5,429	7,085
Securities loaned	545	613	1,227	1,751	1,063	839
Securities failed to receive	889	913	3,379	4,739	2,148	1,704
Payables to other broker-dealers:						
Securities accounts	122	126	242	304	229	204
Commodities accounts	1	2	2	6	3	6
Total net credit balances carried for customers:						
Securities accounts	2,303	2,423	4,508			
Free credit balances	([2])	([2])	([2])	3,637	2,758	2,029
Other credit balances	([2])	([2])	([2])	2,926	2,080	1,689
Commodities accounts	143	171	183			
Free credit balances	([2])	([2])	([2])	50	35	30
Other credit balances	([2])	([2])	([2])	203	151	141
Other liabilities to customers	([2])	([2])	([2])	37	13	16
Net credit balances in accounts of general partners not covered by equity agreements	37	34	46	58	54	47
Short positions in securities and commodities	([2])	([2])	([2])	1,212	743	583
Other liabilities	407	470	1,012	1,403	1,141	1,136
Total liabilities	8,784	9,877	15,762	23,054	15,845	15,509
Capital and subordinated accounts:						
Subordinated loans and accounts	191	209,	306	510	548	559
Accounts covered by equity or subordinated agreements	430	442	651	862	619	487
Secured demand notes contributed as capital	84	81	104	140	146	99
Equity capital	1,210	1,294	1,959	2,453	2,038	1,916
Total liabilities and capital	10,698	11,903	18,783	27,020	19,196	18,570

[1] Revisions in balance sheet form for 1968 made certain items not comparable with earlier years.
[2] Not available.

Note: The balance sheet was not made mandatory until 1968; therefore, some member firms did not file this report during the years 1965, 1966, and 1967. The number of firms not filing a balance sheet in each year was: 29 in 1965, 16 in 1966, and 17 in 1967.

TABLE 17.—STATEMENT OF CAPITAL AND SUBORDINATED ACCOUNTS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

[Dollar amounts in millions]

PART I—CORPORATIONS

Capital and subordinated accounts	All firms	Clearing firms	Nonclearing firms
Subordinated loans and accounts	$376.2	$320.0	$56.2
Secured capital demand notes	93.1	91.6	1.5
Appreciation (depreciation) of market value of exchange memberships	21.7	13.4	8.3
Capital stock outstanding	252.6	228.2	24.4
Capital stock in treasury	(94.9)	(91.4)	(3.5)
Capital surplus	216.5	177.4	39.1
Retained earnings:			
Appropriated	13.2	11.7	1.5
Unappropriated	468.6	421.6	47.0
Total capital funds	1,347.0	1,172.5	174.5
Number of firms	156	84	72
Total liabilities (other than sub.)	$6,427	$5,801	$626
Total assets [1]	$7,767	$6,968	$799

PART II—PARTNERSHIPS

Capital and subordinated accounts	All firms	Clearing firms	Nonclearing firms
Accounts of partners subject to equity or subordination agreements	$619.1	$528.6	$90.6
Subordinated loans and accounts	171.5	167.0	4.5
Secured capital demand notes	53.0	52.5	0.5
Appreciation (depreciation) of market value of exchange membership	45.5	38.8	6.7
Capital accounts:			
General partners	878.7	781.5	97.2
Limited partners	235.9	221.6	14.3
Total capital funds	2,003.7	1,790.0	213.7
Number of firms	223	160	63
Total liabilities (other than sub.)	$9,419	$8,985	$433
Total assets	$11,429	$10,781	$648

Source: NYSE I. & E. reports.

TABLE 17.—PART III, STATEMENT OF FINANCIAL CONDITIONS FOR NYSE CORPORATIONS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
ASSETS			
Cash, clearing funds and other deposits	$540	$481	$59
Receivable from other broker-dealers:			
(1) Securities failed to deliver	748	655	93
(2) Deposits on account of securities borrowed	386	343	43
Receivable from customers	3,759	3,443	316
Accounts of officers, directors and partners not subject to equity or subordination agreements	11	8	3
Long positions in securities and commodities (at market value):			
(1) Investment accounts	130	112	18
(2) Trading and other accounts in which respondent has an interest	1,584	1,382	202
Exchange memberships at market value	118	88	30
roperty, equipment and leasehold improvements net of accumulated depreciation and amortization	96	83	13
Other assets	394	372	22
Total assets	7,767	6,968	799
Number of firms	156	84	72

TABLE 17.—PART III, STATEMENT OF FINANCIAL CONDITIONS FOR NYSE CORPORATIONS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)—Continued

	All firms	Clearing firms	Nonclearing firms
LIABILITIES AND CAPITAL FUNDS			
Money borrowed	$1,725	$1,573	$152
Payable to other broker-dealers:			
(1) Securities failed to receive	964	857	107
(2) Deposits on account of securities loaned	654	575	79
Payable to customers:			
(1) Securities accounts:			
(a) Free credit balances	1,347	1,206	141
(b) Other credit balances	896	816	80
(2) Commodities accounts:			
(a) Free credit balances	26	25	1
(b) Other credit balances	94	91	3
(3) Other liabilities to customers	10	10	
Accounts of officers, directors, and partners not subject to equity or subordination agreements	19	17	2
hort positions in securities and commodities (at market value):			
(1) Investment accounts	2	2	
(2) Trading and other accounts in which respondent has an interest	242	212	30
Other liabilities	446	415	31
Total liabilities	6,427	5,801	626
Capital and subordinated accounts:			
Subordinated accounts	469	411	58
Capital	878	761	117
Total liabilities and capital	7,767	6,968	799

Source: NYSE I. & E. reports.

TABLE 17—PT. IV.—STATEMENT OF FINANCIAL CONDITION FOR NYSE PARTNERSHIPS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS, (YEAR END 1969)

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
ASSETS			
Cash, clearing funds and other deposits	$711	$668	$43
Receivable from other broker-dealers:			
(1) Securities failed to deliver	1,169	1,087	82
(2) Deposits on account of securities borrowed	800	771	29
Receivable from customers	4,065	3,812	253
Accounts of officers, directors and partners not subject to equity or subordination agreements	39	36	4
Long positions in securities and commodities (at market value):			
(1) Investment accounts	621	598	23
(2) Trading and other accounts in which respondent has an interest	3,328	3,163	165
Exchange memberships at market value	159	133	26
Property, equipment and leasehold improvements net of accumulated depreciation and amortization	87	77	9
Other assets	450	437	13
Total assets	11,429	10,781	648
Number of firms	223	160	63

TABLE 17—PT. IV.—STATEMENT OF FINANCIAL CONDITION FOR NYSE PARTNERSHIPS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS, (YEAR END 1969)—Continued

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
LIABILITIES AND CAPITAL FUNDS			
Money borrowed	$3,704	$3,612	$92
Payable to other broker-dealers:			
(1) Securities failed to receive	1,183	1,099	84
(2) Deposits on account of securities loaned	641	584	57
Payable to customers:			
(1) Securities accounts:			
(a) Free-credit balances	1,410	1,291	119
(b) Other credit balances	1,184	1,124	60
(2) Commodities accounts:			
(a) Free-credit balances	9	9	
(b) Other credit balances	57	56	1
(3) Other liabilities to customers	2	1	1
Accounts of officers, directors, and partners not subject to equity or subordination agreements	34	33	2
Short positions in securities and commodities (at market value):			
(1) Investment accounts	137	137	
(2) Trading and other accounts in which respondent has an interest	361	356	5
Other liabilities	695	683	12
Total liabilities	9,419	8,985	433
Capital and subordinated accounts:			
Subordinated accounts	844	748	96
Capital	1,160	1,042	118
Total liabilities and capital	11,429	10,781	648

TABLE 18—PT. I.—STATEMENT OF FINANCIAL CONDITION FOR NYSE CORPORATIONS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
ASSETS			
Cash, clearing funds, and other deposits	$444	$401	$43
Receivable from other broker-dealers:			
(1) Securities failed to deliver	623	546	77
(2) Deposits on account of securities borrowed	355	320	35
Receivable from customers	3,776	3,449	327
Accounts of officers, directors, and partners not subject to equity or subordination agreements	19	17	2
Long positions in securities and commodities (at market value):			
(1) Investment accounts	98	85	13
(2) Trading and other accounts in which respondent has an interest	2,767	2,597	170
Exchange memberships at market value	86	67	19
Property, equipment, and leasehold improvements net of accumulated depreciation and amortization	125	114	11
Other assets	346	321	25
Total assets	8,639	7,917	722
Number of firms	150	93	57

TABLE 18—PT. I.—STATEMENT OF FINANCIAL CONDITION FOR NYSE CORPORATIONS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS, (YEAR END 1970)—Continued

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
LIABILITIES AND CAPITAL FUNDS			
Money borrowed	$2,964	$2,800	$164
Payable to other broker-dealers:			
(1) Securities failed to receive	874	787	87
(2) Deposits on account of securities loaned	622	536	86
Payable to customers:			
(1) Securities accounts:			
(a) Free credit balances	1,133	1,029	104
(b) Other credit balances	857	783	74
(2) Commodities accounts:			
(a) Free credit balances	25	24	1
(b) Other credit balances	96	94	2
(3) Other liabilities to customers	14	14	
Accounts of officers, directors and partners not subject to equity or subordination agreements	30	27	3
Short positions in securities and commodities (at market value):			
(1) Investment accounts	10	10	
(2) Trading and other accounts in which respondent has an interest	215	211	4
Other liabilities	461	424	37
Total liabilities	7,301	6,739	562
Capital and subordinated accounts:			
Subordinated Accounts	459	408	51
Capital	879	770	109
Total liabilities and capital	8,639	7,917	722

TABLE 18—PT. II.—STATEMENT OF FINANCIAL CONDITION FOR NYSE PARTNERSHIPS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
ASSETS			
Cash, clearing funds and other deposits	$510	$477	$33
Receivable from other broker-dealers:			
(1) Securities failed to deliver	823	783	40
(2) Deposits on account of securities borrowed	597	572	25
Receivable from customers	2,840	2,655	185
Accounts of officers, directors and partners not subject to equity or subordinate agreements	32	26	6
Long positions in securities and commodities (at market value):			
(1) Investment accounts	1,027	1,009	18
(2) Trading and other accounts in which respondent has an interest	3,520	3,366	154
Exchange memberships at market value	100	82	18
Property, equipment and leasehold improvements net of accumulated depreciation and amortization	76	70	6
Other assets	404	396	8
Total assets	9,929	9,436	493
Number of firms	183	129	54

TABLE 18—PT. II.—STATEMENT OF FINANCIAL CONDITION FOR NYSE PARTNERSHIPS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)—Continued

[Dollar amounts in millions]

	All firms	Clearing firms	Nonclearing firms
LIABILITIES AND CAPITAL FUNDS			
Money borrowed	$4,122	$4,035	$87
Payable to other broker-dealers:			
(1) Securities failed to receive	830	786	44
(2) Deposits on account of securities loaned	427	375	52
Payable to customers:			
(1) Securities accounts:			
(a) Free-credit balances	895	824	71
(b) Other credit balances	833	785	48
(2) Commodities accounts:			
(a) Free-credit balances	5	5	
(b) Other credit balances	45	43	2
(3) Other liabilities to customers	1		1
Accounts of officers, directors, and partners not subject to equity or subordination agreements	17	16	1
Short positions in securities and commodities (at market value).			
(1) Investment accounts	110	110	
(2) Trading and other accounts in which respondent has an interest	248	244	4
Other liabilities	674	667	7
Total liabilities	8,207	7,890	317
Capital and subordinated accounts:			
Subordinated accounts	687	589	98
Capital	1,035	957	78
Total liabilities and capital	9,929	9,436	493

TABLE 19.—COMPOSITION OF THE CAPITAL STRUCTURE FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

PART I

	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
Equity capital as a percentage of equity capital:						
Less than 10	4	16	4	11	0	5
10 to 19.9	0	20	0	10	0	10
20 to 29.9	10	10	8	7	2	3
30 to 39.9	24	16	16	14	8	2
40 to 49.9	16	13	11	7	5	6
50 to 59.9	20	21	17	17	3	4
60 to 69.9	19	9	9	5	10	4
70 to 79.9	14	15	4	13	10	2
80 to 89.9	13	21	7	15	6	6
90 to 99.9	14	11	8	7	6	4
100 percent	16	31	9	23	7	8
Total	150	183	93	129	57	54

PART II

	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
Subordinated loans and accounts as a percentage of total capital:						
0	17	117	10	74	7	43
0.1 to 9.9	17	21	11	18	6	3
10 to 19.9	16	14	9	12	7	2
20 to 29.9	15	10	4	9	11	1
30 to 39.9	18	9	9	7	9	2
40 to 49.9	17	5	15	3	2	2
50 to 59.9	14	5	9	4	5	1
60 to 69.9	23	2	15	2	8	0
70 and over	13	0	11	0	2	0
Total	150	183	93	129	57	54

Source: NYSE I. & E. reports.

TABLE 19.—COMPOSITION OF THE CAPITAL STRUCTURE FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)—Continued

PART III

Secured capital demand notes as a percentage of total capital	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
0	136	175	81	123	55	52
0.1 to 9.9	3	1	3	1	0	0
10 to 19.9	4	2	3	1	1	1
20 to 29.9	2	1	1	1	1	0
30 to 39.9	1	3	1	2	0	1
40 to 49.9	1	0	1	0	0	0
50 to 59.9	2	1	2	1	0	0
60 to 69.9	1	0	1	0	0	0
70 and over	0	0	0	0	0	0
Total	150	183	93	129	57	54

PART IV

Accounts of partners subject to equity or subordination agreements as a percentage of total capital	All partnerships	Clearing partnerships	Nonclearing partnerships
0	53	37	16
0.1 to 9.9	15	12	3
10 to 19.9	24	20	4
20 to 29.9	10	6	4
30 to 39.9	9	7	2
40 to 49.9	11	9	2
50 to 59.9	11	7	4
60 to 69.9	14	13	1
70 and over	36	18	18
Total	183	129	54

Source: NYSE I. & E. Report.

TABLE 20.—COMPOSITION OF THE CAPITAL STRUCTURE FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

PART I

	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
Equity capital as a percentage of total capital:						
Less than 10	6	18	4	12	2	6
10 to 19.9	3	15	2	12	1	3
20 to 29.9	10	14	7	9	3	5
30 to 39.9	15	28	11	20	4	8
40 to 49.9	17	21	11	17	6	4
50 to 59.9	19	22	12	15	7	7
60 to 69.9	24	11	11	9	13	2
70 to 79.9	14	17	5	12	9	5
80 to 89.9	23	25	12	19	11	4
90 to 99.9	12	12	5	8	7	6
100 percent	13	40	4	27	9	13
Total	156	223	84	160	72	63

PART II

	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
Subordinated loans and accounts as a percentage of total capital:						
0	16	146	7	99	9	47
0.1 to 9.9	17	27	9	23	8	4
10 to 19.9	22	21	11	16	11	5
20 to 29.9	16	7	6	4	10	3
30 to 39.9	23	10	10	8	13	2
40 to 49.9	16	6	11	5	5	1
50 to 59.9	16	3	10	3	6	0
60 to 69.9	12	1	8	0	4	1
70 and over	18	2	12	2	6	0
Total	156	223	84	160	72	63

Source: NYSE I. & E. reports.

TABLE 20.—COMPOSITION OF THE CAPITAL STRUCTURE FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)—Continued

PART III

Secured capital demand notes as a percentage of total capital	All firms		Clearing firms		Nonclearing firms	
	Corporate	Partnerships	Corporate	Partnerships	Corporate	Partnerships
0	140	212	71	151	69	61
0.1 to 9.9	3	4	2	3	1	1
10 to 19.9	4	2	3	2	1	0
20 to 29.9	3	2	3	1	0	1
30 to 39.9	3	1	2	1	1	0
40 to 49.9	0	0	0	0	0	0
50 to 59.9	2	1	2	1	0	0
60 to 69.9	0	1	0	1	0	0
70 and over	1	0	1	0	0	0
Total	156	223	84	160	72	63

PART IV

Accounts of partners subject to equity or subordination agreements as a percentage of total capital	All partnerships	Clearing partnerships	Nonclearing partnerships
0	60	39	21
0.1 to 9.9	18	14	4
10 to 19.9	27	24	3
20 to 29.9	16	12	4
30 to 39.9	12	8	4
40 to 49.9	17	11	6
50 to 59.9	12	10	2
60 to 69.9	23	17	6
70 and over	38	25	13
Total	223	160	63

Source: NYSE I. & E. reports.

TABLE 21, PT. I—EQUITY CAPITAL AS A PERCENT OF TOTAL CAPITAL FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

Equity capital as a percentage of total capital [1]	All firms, by asset size (in millions of dollars)							
	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Negative	1	3	1	2	1	0	0	8
0	0	0	0	0	0	0	0	0
0 to 9.9	0	1	5	3	2	0	1	12
10 to 19.9	2	7	7	3	0	0	1	20
20 to 29.9	3	2	4	5	3	2	1	20
30 to 39.9	5	10	10	9	5	1	0	40
40 to 49.9	7	3	9	7	0	1	2	29
50 to 59.9	4	8	12	7	2	6	2	41
60 to 69.9	5	10	6	1	2	3	1	28
70 to 79.9	5	10	9	3	0	2	0	29
80 to 89.9	7	8	5	6	3	4	1	34
90 to 99.9	6	5	11	1	0	2	1	26
100	15	10	6	7	2	3	3	46
Total	60	77	85	54	20	24	13	333

TABLE 21, PT. II.—EQUITY CAPITAL AS A PERCENTAGE OF TOTAL CAPITAL FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

Equity capital as a percentage of total capital[1]	All firms, by asset size (in millions of dollars)							
	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Negative	0	7	2	1	0	1	0	11
0	1	0	0	0	0	0	0	1
0.1 to 9.9	1	0	6	2	3	0	0	12
10 to 19.9	0	7	6	1	2	1	1	18
20 to 29.9	2	6	5	4	2	3	2	24
30 to 39.9	7	6	15	8	4	2	1	43
40 to 49.9	6	2	9	13	3	3	2	38
50 to 59.9	4	9	14	6	5	1	2	41
60 to 69.9	4	4	15	5	4	3	0	35
70 to 79.9	6	7	7	6	2	2	1	31
80 to 89.9	12	10	11	4	4	5	2	48
90 to 99.9	4	7	7	2	2	1	1	24
100	18	8	11	9	3	1	3	53
Total	65	73	108	61	34	23	15	379

[1] Equity capital is defined as total assets less total liabilities and subordinated borrowings.

Source: NYSE I. & E. reports.

TABLE 22, PT. I.—TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

Debt-asset ratio (in percentages)	All firms by asset size (in millions of dollars)							
	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Under 50	3	1	1	1	1	0	0	7
50 to 54.9	3	1	0	1	0	0	0	5
55 to 59.9	5	1	0	1	0	0	0	7
60 to 64.9	3	1	2	0	0	1	0	7
65 to 69.9	2	5	4	1	1	1	0	14
70 to 74.9	11	7	5	2	0	0	0	25
75 to 79.9	6	7	8	3	0	1	0	25
80 to 84.9	11	15	9	6	1	5	0	47
85 to 89.9	10	19	25	13	4	7	3	81
90 to 94.9	5	16	19	14	6	7	5	72
95 and over	1	4	12	12	7	2	5	43
Total firms	60	77	85	54	20	24	13	333

Source: NYSE I. & E. reports.

TABLE 22. PART II.—CONCENTRATION OF ASSETS AMONG NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

Member firms asset size (millions)	Number of firms	Total assets (millions)	Cumulative totals		
			Number of firms	Total assets (millions)	Percentage
$250 and over	15	$8,584	15	$8,584	44.7
$100 to $249.9	23	3,726	38	12,310	64.1
$50 to $99.9	34	2,287	72	14,597	76.0
$25 to $49.9	61	2,094	133	16,691	87.0
$10 to $24.9	108	1,771	241	18,462	96.2
$5 to $9.9	73	544	314	19,006	99.0
Under $5	65	190	379	19,196	100.0
Total	379	19,196			

PART III.—CONCENTRATION OF EQUITY CAPITAL AMONG NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

			Cumulative totals		
Member firms asset size (millions)	Number of firms	Equity capital [1] (millions)	Number of firms	Equity capital (millions)	Percent
$250 and over	15	$724	15	$724	35.5
$100 to $249.9	23	371	38	1,095	53.7
$50 to $99.9	34	277	72	1,372	67.3
$25 to $49.9	61	282	133	1,654	81.1
$10 to $24.9	108	251	241	1,905	93.4
$5 to $9.9	73	85	314	1,990	97.6
Under $5	65	48	379	2,038	100.0
Total	379	2,038			

[1] Equity capital is defined as total assets less total liabilities and subordinated borrowings.

Source: NYSE I & E reports, Office of Policy Research.

TABLE 22.—PART IV, TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

[All firms by asset size; In millions of dollars]

Debt-asset ratio (percentage)	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Under 50.0	5	1	1	1	1	0	0	9
50.0 to 54.9	2	1	2	0	0	0	0	5
55.0 to 59.9	3	1	0	1	1	0	0	6
60.0 to 64.9	10	4	4	2	0	0	0	20
65.0 to 69.9	6	2	2	1	0	1	0	12
70.0 to 74.9	6	5	5	2	0	0	0	18
75.0 to 79.9	9	6	7	5	0	1	0	28
80.0 to 84.9	7	14	9	7	2	3	1	43
85.0 to 89.9	13	15	35	14	14	4	3	98
90.0 to 94.9	2	13	25	17	9	9	7	82
95.0 and over	2	11	18	11	7	5	4	58
Total	65	73	108	61	34	23	15	379

Source: NYCE I. & E. reports.

TABLE 22.—PART V, TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1968)

[All firms by asset size; millions of dollars]

Debt-asset ratio (percentage)	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Under 50 0	7	0	0	2	0	0	0	8
50 0 to 54.9	2	1	0	0	0	0	0	9
55.0 to 59.9	1	3	2	0	1	1	0	3
60 0 to 64.9	3	1	1	0	0	0	0	5
65.0 to 69.9	5	3	5	0	2	0	0	15
70.0 to 74.9	4	4	7	0	1	1	0	17
75.0 to 79.9	6	9	5	2	1	0	0	23
80.0 to 84 9	7	21	18	7	3	3	0	59
85.0 to 89.9	3	9	36	15	12	7	5	87
90 0 to 94 9	0	7	28	32	21	12	12	112
95.0 and over	0	0	8	8	18	6	7	47
Total	38	58	110	66	59	30	24	385

Source: NYSE I. & E. reports.

TABLE 23.—PART I, LIABILITIES, OTHER THAN SUBORDINATED BORROWINGS, AS A PERCENTAGE OF TOTAL ASSETS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1970)

[All firms by asset size; in millions of dollars]

Debt-asset ratio (percentage)	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Less than 20.0	1	0	1	0	0	0	0	0
20.0 to 24.9	0	0	0	0	0	0	0	2
25.0 to 29.9	1	0	1	0	0	0	0	2
30.0 to 34.9	4	0	1	0	0	0	0	5
35.0 to 39 9	1	2	2	0	1	0	0	6
40.0 to 44.9	3	0	1	0	0	0	0	4
45.0 to 49.9	2	2	2	1	0	0	0	7
50.0 to 54.9	7	4	2	3	0	0	0	16
55.0 to 59.9	5	6	4	1	0	0	0	16
60.0 to 64 9	5	7	0	2	0	2	0	16
65.0 to 69.9	8	10	8	6	2	0	0	34
70.0 to 74.9	12	11	17	7	0	1	0	48
75.0 to 79.9	5	20	19	13	5	6	2	70
80.0 to 84.9	4	14	22	13	10	9	3	75
85.0 to 89.9	2	1	4	6	2	5	4	24
90.0 and over	0	0	1	2	0	1	4	8
Total firms	60	77	85	54	20	24	13	333

Source: NYSE I. & E. reports.

TABLE 23—PART II, LIABILITIES, OTHER THAN SUBORDINATED BORROWINGS, AS A PERCENTAGE OF TOT AL ASSESTS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

[All firms by asset size; in millions of dollars]

Debt-asset ratio (percentage)	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Less than 20.0	2	0	0	0	0	0	0	2
20.0 to 24.9	0	0	1	0	0	0	0	1
25.0 to 29.9	0	0	1	0	0	0	0	1
30.0 to 34.9	0	1	1	0	0	0	0	2
35.0 to 39.9	2	1	2	0	1	0	0	6
40.0 to 44.9	6	0	1	1	0	0	0	8
45.0 to 49.9	6	2	1	0	0	0	0	9
50 0 to 54.9	1	2	2	1	1	0	0	7
55.0 to 59.9	6	4	2	1	0	0	0	13
60.0 to 64.9	10	8	9	4	1	1	0	33
65.0 to 69.9	10	9	10	2	1	0	0	32
70.0 to 74.9	9	11	13	11	2	1	1	48
75.0 to 79.9	10	19	25	10	6	1	0	71
80.0 to 84.9	3	13	24	14	13	15	4	86
85 0 to 89.9	0	3	16	15	9	4	6	53
90.0 and over	0	0	0	2	0	1	4	7
Total firms	65	73	108	61	34	23	15	379

Source: NYSE I. & E. reports.

TABLE 23.—PART III, LIABILITIES, OTHER THAN SUBORDINATED BORROWINGS, AS A PERCENTAGE OF TOTAL ASSETS FOR NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1968)

[All firms by asset size; in millions of dollars]

Debt-asset ratio (percentage)	$0 to $4.9	$5 to $9.9	$10 to $24.9	$25 to $49.9	$50 to $99.9	$100 to $249.9	$250 and over	Total
Less than 20.0	2	0	0	0	0	0	0	2
20.0 to 24.9	0	0	0	0	0	0	0	0
25.0 to 29.9	2	0	2	1	0	0	0	5
30.0 to 34.9	1	1	2	0	0	0	0	4
35 0 to 39.9	2	1	0	0	0	0	0	3
40.0 to 44.9	0	0	0	0	0	0	0	0
45.0 to 49.9	2	2	1	1	0	1	0	7
50.0 to 54 9	2	3	1	2	1	0	0	9
55.0 to 59.9	6	3	3	0	0	1	0	13
60.0 to 64.9	3	3	7	0	0	2	0	15
65.0 to 69.9	10	6	11	4	3	1	0	35
70.0 to 74.9	5	9	10	2	5	1	0	32
75.0 to 79.9	2	10	22	10	4	2	0	50
80.0 to 84.9	0	15	31	22	22	4	2	96
85.0 to 89.9	1	5	16	20	18	14	17	91
90.0 and over	0	0	4	4	6	4	5	23
Total	38	58	110	66	59	30	24	385

Source: NYSE I. & E. reports.

TABLE 24

PART I.—LIABILITIES, OTHER THAN SUBORDINATED BORROWINGS, AS A PERCENTAGE OF TOTAL ASSETS FOR SELECTED BROKER-DEALERS (YEAR END 1970)

Percent	NASD only	All exchanges except NYSE	Total
0	3	2	5
Under 20	45	27	72
20 to 24.9	7	3	10
25 to 29.9	18	7	25
30 to 34.9	11	12	23
35 to 39.9	22	10	32
40 to 44.9	27	11	38
45 to 49.9	23	14	37
50 to 54.9	19	19	38
55 to 59.9	32	25	57
60 to 64.9	35	35	70
65 to 69.9	39	39	78
70 to 74.9	33	49	82
75 to 79.9	21	45	66
80 to 84.9	30	45	75
85 to 89.9	12	21	33
90 to 94.9	8	8	16
95 to 99.9	3	1	4
Over 100	—	—	—
Total	388	373	761

PART II.—TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR SELECTED BROKER-DEALERS (YEAR END 1970)

Percentage	NASD Only	All exchanges except NYSE	Total
0	4	2	6
Under 20	37	20	57
20 to 24.9	4	2	6
25 to 29.9	14	5	19
30 to 34.9	10	7	17
35 to 39.9	17	9	26
40 to 44.9	23	5	28
45 to 49.9	18	7	25
50 to 54.9	17	13	30
55.9 to 59.9	26	14	40
60 to 64.9	26	19	45
65 to 69.9	35	22	57
70 to 74.9	25	39	64
75 to 79.9	23	37	60
80 to 84.9	33	52	85
85 to 89.9	20	43	63
90 to 94.9	17	35	52
95 to 99	19	18	37
100	1	2	3
Over 100	19	22	41
Total	388	373	761

Source: X-17A-10 Reports 1970

TABLE 25—PT. I.—SUBORDINATED ACCOUNTS AS A PERCENTAGE OF TOTAL CAPITAL FOR 284 NYSE MEMBER FIRMS CARRYING PUBLIC CUSTOMER ACCOUNTS (YEAR END 1965–69)

Subordinated accounts as a percentage of total capital	1965	1966	1967	1968	1969
0	69	63	62	48	42
Under 10	27	24	19	25	20
10 to 19.9	11	15	22	30	33
20 to 29.9	30	29	34	31	22
30 to 39.9	23	26	33	27	25
40 to 49.9	21	24	24	33	28
50 to 59.9	36	34	34	30	28
60 to 69.9	21	19	17	19	35
70 to 79.9	22	23	22	22	20
80 to 89.9	18	18	14	13	13
90 and over	5	9	3	6	18
Total	284	284	284	284	284

TABLE 25—PT. II.—TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR 284 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969)

Debt-asset ratio (percentage)	1965	1966	1967	1968	1969
Under 50	17	14	14	5	5
50 to 54.9	4	4	1	3	5
55 to 59.9	8	5	6	8	6
60 to 64.9	10	8	10	4	15
65 to 69.9	10	15	7	13	5
70 to 74.9	14	30	14	10	12
75 to 79.9	22	17	34	20	24
80 to 84.9	28	34	39	44	32
85 to 89.9	70	62	59	61	77
90 to 94.9	74	68	76	78	59
95 and over	27	27	24	38	44
Total	284	284	284	284	284

TABLE 25—PT. III.—TOTAL LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS FOR 284 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1965–69)

Debt-asset ratio (percentage)	1965	1966	1967	1968	1969
Less than 20	5	4	5	2	2
20 to 24.9	4	4	0	0	1
25 to 29.9	3	3	4	2	0
30 to 34.9	3	2	3	2	2
35 to 39.9	5	3	2	3	3
40 to 44.9	7	6	4	0	6
45 to 49.9	10	9	5	6	8
50 to 54 9	9	13	9	7	6
55 to 59.9	13	13	14	12	9
60 to 64.9	22	24	18	10	22
65 to 69 9	25	27	26	30	24
70 to 74.9	23	42	26	21	36
75 to 79.9	37	24	46	38	52
80 to 84 9	47	57	57	73	65
85 to 89.9	58	43	50	64	43
90 to 94.9	11	8	15	12	5
95 and over	2	2	0	2	0
Total	284	284	284	284	284

Source: NYSE I. & E. reports.

TABLE 25—PT. IV.—SUBORDINATED ACCOUNTS AS A PERCENTAGE OF TOTAL CAPITAL FOR 324 NYSE MEMBER FIRMS CARRYING PUBLIC CUSTOMER ACCOUNTS (YEAR END 1969–70)

Subordinated accounts as a percentage of total capital	1969	1970
0	48	46
Under 10	24	25
10 to 19 9	43	35
20 to 29.9	29	28
30 to 39.9	30	27
40 to 49.9	30	38
50 to 59.9	34	28
60 to 69.9	36	39
70 to 79.9	18	19
80 to 89.9	14	19
90 and over	18	20
Total	324	324

TABLE 25—PT. V.—TOTAL LIABILITIES (INCLUDING SUBORDINATED BORROWINGS) AS A PERCENTAGE OF TOTAL ASSETS FOR 324 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969-70)

Debt-asset ratio (percentage)	1969	1970
Under 50.0	8	7
50 to 54.9	4	5
55 to 59.9	6	7
60 to 64.9	17	7
65 to 69.9	10	14
70 to 74.9	16	24
75 to 79.9	25	24
80 to 84.9	40	45
85 to 89.9	87	79
90 to 94.9	68	70
95 and over	43	42
Total	324	324

TABLE 25—PT. VI.—TOTAL LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS FOR 324 NYSE MEMBER FIRMS CARRYING ACCOUNTS OF PUBLIC CUSTOMERS (YEAR END 1969-70)

Debt-asset ratio (percentage)	1969	1970
Less than 20	0	1
20 to 24.9	1	1
25 to 29 9	1	2
30 to 34.9	2	5
35 to 39.9	4	6
40 to 44.9	8	4
45 to 49.9	6	7
50 to 54.9	6	15
55 to 59.9	13	14
60 to 64.9	31	19
65 to 69.9	29	30
70 to 74.9	40	46
75 to 79.9	62	69
80 to 84.9	70	73
85 to 89.9	44	24
90 to 94.9	7	6
95 and over	0	2
Total	324	324

Source: NYSE I. & E. reports.