UNITED STATES OF AMERICA

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

IN THIS MATTER OF

Richard Whitney, Edwin D. Morgan, Jr., F. Kingsley Rodewald, Henry D. Mygatt, Daniel G. Condon, John J. McManus, and Estate of John A. Hayes, individually and as partners doing business as Richard Whitney & Company

PURSUANT TO SECTION 21 (A) OF THE SECURITIES EXCHANGE ACT OF 1934

VOLUME I

Report on Investigation

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COMMISSIONERS

William O. Douglas, Chairman
George C. Mathews
Robert E. Healy
Jerome N. Frank
John W. Hanes [Footnote: Resigned June 30, 1938]

Francis P. Brassor, Secretary

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FOREWORD

Volume I contains the report of the Securities and Exchange Commission on its investigation in the matter of Richard Whitney, et al. This report is based on facts adduced by the Commission at public hearings held pursuant to the Commission's order of April 6, 193i8, following its investigation pursuant to an order of March 8, 1938. These public hearings, which begun on April 8, 1938 and ended June 29, 1938, were conducted by Gerhard A. Gesell, Senior Attorney, before Samuel O. Clark, Jr., Trial Examiner. During the course of these hearings John K. Davidson, Senior Attorney, developed information concerning the financial condition of Richard Whitney & Company, based on this Commission's examination of the books and records of that firm.

In these proceedings the New York Stock Exchange was represented by Dean Acheson and Edward Burling, Jr., of Covington, Burling, Rublee, Acheson and Shorb. Other counsel appearing in the proceedings were: Alfred A. Cook and Nathan Greene, of Cook, Nathan and Lehman, representing E. H. H. Simmons; M. J. Callahan, of Simpson, Thacher and Bartlett, representing Kenneth B. Schley; Samuel T. Gilman, of Gilman & Unger, representing Alexander B. Gale; and Charles H. Tuttle, L. Randolph Mason, and W. K. Petigrue, representing Richard Whitney.

Volume I, which contains the Commission's report, is divided into three, parts. Part I of the report, which contains a statement of the facts of the case, was prepared under the direction of Trial Examiner Clark, with the assistance of Richard Ainsworth, Associate Attorney. Part II of the report reflects not only the reforms recently inaugurated or announced by the new management of the New York Stock Exchange, headed by its president, William McC. Martin, Jr., but also the Commission's program under the Securities Exchange Act of 1934, respecting the protection of customers of brokerage houses. In the development of this program the Commission was represented by Ganson Purcell, Director of the Trading and Exchange Division, assisted by Francis T. Greene and James A. Treanor, Jr., Assistant, Directors, and Walter C. Louchheim, Jr., Assistant to the Director. Part III contains the conclusions of the Commission.

Volume II contains a complete transcript of the testimony taken in the public hearings.

Volume III contains all the exhibits introduced in evidence during the public hearings.

PART I
STATEMENT OF FACTS

SECTION I

INTRODUCTION

On the morning of March 8, 1938, Charles R. Gay, President of the New York Stock Exchange, announced from the rostrum of the Exchange that the firm of Richard Whitney & Company had been suspended for insolvency. A statement released by the Exchange immediately thereafter definitely indicated that the firm had been guilty of misconduct. On the same day the firm and its general partners filed voluntary petitions in bankruptcy and were adjudicated bankrupt. On March 17, 1938, Richard Whitney, the senior partner of the firm, was expelled from the New York Stock Exchange and two other partners, Edwin D. Morgan, Jr., and Henry D. Mygatt, who also were members of the Exchange, were suspended for three years. Shortly after March 8, 1938, Richard Whitney was arrested on two separate indictments charging him with grand larceny in the first degree for appropriating to his own use securities entrusted to him in a fiduciary capacity. To these indictments he pleaded guilty and, on April 11, 1938, was sentenced to an indeterminate term of five to ten years in Sing Sing prison on each indictment, the terms to run concurrently. [Footnote: The facts summarized in this paragraph are developed more fully in the body of this report.]

Subsequent investigation has disclosed that for at least three and a half years prior to its failure, Richard Whitney & Company had conducted its business as a member firm of the New York Stock Exchange while insolvent. It was further disclosed that Richard Whitney, as far back as 1926, had misappropriated a customer's securities entrusted to his care, and that, beginning in 1930, such misappropriations became his regular practice. [Footnote: These facts are treated in detail in the body of this report.] These circumstances, coupled with the fact that no disciplinary action was taken by the New York Stock Exchange against Richard Whitney until March of this year make pertinent a consideration of the adequacy and the operation of the then existing machinery of the New York Stock Exchange for the supervision and surveillance of its members.

The Commission first received information concerning Richard Whitney's misconduct and the financial distress of his firm on the evening of March 7, 1938. Charles R. Gay, President of the Exchange, and Howland S. Davis, Chairman of the Committee on Business Conduct, left for Washington shortly after the

Governing Committee in the afternoon of the same day voted to prefer charges against Richard Whitney and two of his partners. Upon their arrival they advised Chairman William O. Douglas and John W. Hanes, then a member of the Commission, of the action taken by the Governing Committee and the developments which had led thereto. At about 10 or 10:30 A. M. on March 8, 1938, an investigation of the books and records of Richard Whitney & Company was commenced by members of the Commission's staff. [Footnote: Proceedings before the Securities and Exchange Commission in the Matter of Richard Whitney, Edwin D. Morgan, Jr., F. Kingsley Rodewald, Henry D. Mygatt, Daniel G. Condon, John J. McManus, and Estate of John A. Hayes, individually and as partners doing business as Richard Whitney & Company, Vol. II, Transcript of Hearings (1938), at 407-408, 760. For convenience all subsequent citations to the testimony in the record (published in Volume II) will be stated in abbreviated form, E.G. R.407-408. Likewise, all citations to exhibits admitted in evidence and published in Volume III, will be similarly abbreviated, e.g. Ex. P-1. Unless otherwise noted all exhibits cited are exhibits offered in evidence by the Commission.] On April 6, 1938, following this investigation, the Commission ordered that a public hearing be held to ascertain the facts, conditions, practices, and matters antecedent to and culminating in the failure of the firm of Richard Whitney & Company and the disciplinary action by the Exchange against the three member partners of the firm in order to determine the necessity for additional legislation or rules and regulations affecting national securities exchanges registered with the Commission under the Securities Exchange Act of 1934.

[Footnote: The public hearing was held pursuant to Section 21 (a) of the Securities Exchange Act of 1934, which reads:

"The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate any provision of this title or any rule or regulation thereunder, and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized, in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this title relates."

The Commission's order of April 6, 1938, reads in part:

"It is ordered, pursuant to Section 21 (a) of the Securities Exchange Act of 1934, as amended, that a public hearing to be held to determine the facts, conditions, practices, and matters antecedent to and culminating in such suspension and disciplinary action to aid (1) in the enforcement of the provisions of the Securities Exchange Act of 1934, as amended, (2) in prescribing the rules and regulations pursuant to Sections 8 (b) and (c), 11 (a), 16 (a), 17 (a), 19 (b) (1), (6), (7), and (13), and other pertinent provisions of such Act, as amended, and (3) in securing information to serve as a basis for recommendation by the Commission of such further legislation concerning any matters to which such Act as amended relates as may appear to it to be necessary or appropriate; * * *" Ex. P-1."

Fifty-two witnesses testified in the course of the public hearings, which were held on 14 days between April 8, 1938, and June 29, 1938, inclusive, in New York and Washington. Throughout these proceedings the New York Stock Exchange was represented by counsel, as were all witnesses who desired counsel. An opportunity was accorded such counsel to examine witnesses called by the Commission and to call witnesses to adduce proof on behalf of their clients. During the entire course of the proceedings the New York Stock Exchange and its counsel extended the fullest cooperation to this Commission in making available to it all pertinent records and documents, in arranging for the appearance of witnesses who were members or employees of the New York Stock Exchange, and generally in facilitating the conduct of the hearing. The record of the public examination, comprising 937 printed pages of testimony and over 100 exhibits, forms the basis of this report.

PART II

RECOMMENDATIONS

Part I of this Report has related the chain of events which led up to and attended the eventual failure of Richard Whitney & Company, followed as it was by the losses which resulted from Richard Whitney's misuse of customers' funds and his embezzlement of their securities. There has been described the disciplinary action taken by the New York Stock Exchange when its responsible officials became aware of Richard Whitney's defalcation. There has also been set forth in detail the limited facilities provided by the former management of the Exchange for the supervision of the affairs of the members.

After the events described in Part I had occurred, the earlier plans for reorganization of the administrative machinery of the New York Stock Exchange and for the installation of a new management were speedily completed. That new management has been working cooperatively with this Commission in an endeavor to raise the standards of practices of the Exchange members and to improve the system which permitted Richard Whitney to operate to the detriment of the financial community for almost twelve years without let or hindrance.

PROGRAM OF THE NEW YORK STOCK EXCHANGE

The new management of the New York Stock Exchange has proposed to inaugurate various measures as an immediate step toward strengthening and improving methods of regulation by the Exchange of its own affairs and of the relations between the members and the public. The program (see appendix A (page 173) for its full text) includes the following:

1. Financial Statement; Questionnaires. -- Provisions for increased supervision of the conduct of members' business by the Exchange, through increase of financial statement requirements and examinations. It is proposed to increase the number of periodic financial statements, or "questionnaires," required to be filed with the Exchange and to require annual independent audits of firms doing a public business. The Exchange will undertake supervisory audits and more frequent examination and inspection of member firms by Exchange auditors at irregular intervals and without prior warning.

2. Margin Transactions. -- Prohibition of margin transactions and the maintenance of margin accounts by member firms and by partners of member firms doing a business with the public. This proposal is aimed at removing further risks to public customers growing out of speculative activity for the account of the house or its partners.

3. Capital and Indebtedness Relationship. -- Establishment of a 15 to 1 ratio between a broker's indebtedness and his working capital.

4. Separation of Brokerage and Dealer Capital. -- Separation of capital employed in the brokerage business by firms doing business with the public from that used in incurring commitments by the broker as an underwriter or dealer. As a part of this measure, the Exchange proposes to encourage the formation of separate corporate affiliates of brokerage firms to handle the dealer and underwriting activities, thus attempting to insulate brokerage customers from the risks inherent in underwriter and dealer commitments. In this connection, the desirability of making such a program a requirement for all such firms is clearly set forth in a letter of the President of the New York Stock Exchange to the Commission, dated October 24, 1938 :

> Office of the President.
>
> New York Stock Exchange

New York, October 24, 1938

Hon. William O. Douglas
Chairman, Securities and Exchange Commission
Washington, D.C.

Dear Mr. Douglas: Along the lines of our many conversations, I agree with you it would be in the interest of the public ultimately to separate capital employed in the commission brokerage business from that used in incurring commitments by the broker as an underwriter or dealer.

This marks, however, so fundamental a change in the business and affects directly so many of the smaller firms throughout the country in particular, I think it is necessary to feel our way carefully and give the firms every opportunity to work out the problems involved.

To that end the Exchange is raising its capital requirements and at the same time will endeavor to encourage the formation of separate corporate affiliates of brokerage firms to handle the dealer and underwriting activities. This will be done on a permissive basis, and while I hope this can be made a definite requirement later, the final decision must rest on the evidence supplied by actual experience. Sincerely yours,

Wm. McC. Martin, Jr.,
President

5. Special Loans. -- A requirement that members and member firms and partners thereof report to the Exchange all substantial loans made to or by such persons or firms except those fully secured by readily marketable collateral. It is also proposed in this connection to prohibit, so far as members are concerned, the making of any unsecured loan by or to any governor of the Exchange or any officer or employee thereof, unless the prior written approval of the appropriate committee is obtained.

6. Current Underwriting Information. -- A requirement that weekly information as to underwriting positions by members and any affiliated dealer corporations be filed with the Exchange.

7. Central Securities Depository. -- In addition, the New York Stock Exchange plans to establish for its membership a central securities depository, to receive, hold, and make deliveries of customers' securities whether margin, excess collateral, or safekeeping. This proposal is outlined in a letter received by the

Commission from the President of the New York Stock Exchange under date of October 24, 1938 :

William McC. Martin, Jr.,
President

New York Stock Exchange
Eleven Wall Street, October 24, 1938

Hon. William O. Douglas
Chairman, Securities and Exchange Commission
Washington, D.C.

Dear Mr. Douglas: As you know, the New York Stock Exchange has been considering the desirability, from the viewpoint of the public interest and the interest of our member firms, of a central depository for the securities of customers. Particularly in light of your suggestions, we have been examining all aspects of brokers' responsibility in delivering and safekeeping customers' securities.

To test our judgment as to the feasibility of a central depository and to determine finally its organization and maintenance costs, Haskins & Sells, public accountants, were retained to make a thorough study. Meanwhile, counsel are studying the legal aspects and technicians are examining technical phases of the problem. Definite progress is being made with these studies.

As yet, the Exchange is not in a position to gauge the obstacles to the practical organization, by the Exchange or by banks, of a depository for customers' and brokers' securities. Despite the belief of many, including myself, that such a depository would offer desirable advantages, the Exchange in the end must test its acceptability by balancing costs against economies ascribable to its functioning and by assessing its custodial usefulness.

May I say that, as President of the New York Stock Exchange, I fully recognize the indicated benefits of such a central institution. I expect to urge upon our Board of Governors that the facilities of a depository of this character be made available as soon as practicable.

An undertaking of this magnitude presents many problems. I am hopeful, however, that, with the cooperation of various sections of this financial community, we can find the solution of these problems, and I shall keep you informed of our progress.

Sincerely yours,

Wm. McC. Martin, Jr.,
President

The foregoing program is a constructive approach to many of the problems which are the products of the system so jealously protected by the old regime. It evidences the process which a progressive exchange should constantly undergo as it seeks through effective regulation to render greater service and to afford increased safety to its customers. Such steps are inevitable in a securities business in which we find combined in single firms and single individuals such disparate functions as those of broker and dealer and broker and banker.

The program of the New York Stock Exchange is suggestive of an appropriate commencement toward the solution of the many similar problems existing in other parts of our national securities markets. The Commission therefore recommends that the other national securities exchanges, as well as brokers and dealers contemplating the formation of national securities associations under the recently enacted Section 15A of the Act, consider and appraise these proposals in the light of the situations peculiar to each. Certain of the measures which the New York Stock Exchange has proposed may not be applicable to members of all of the other securities exchanges or to all brokers and dealers. But a large measure of adaptation is possible.

PROGRAM OF THE COMMISSION

However, adoption of rules by this Commission is also desirable in order to assure uniform business practices by all brokers whether or not members of a national securities exchange. Rules of this Commission are further necessary in order to supplement and to strengthen the programs of regulation which are undertaken by the exchanges themselves. [Footnote: Under Section 10 (b) of the Securities Exchange Act of 1934 the Commission is empowered to alter or supplement the rules of national securities exchanges in relation to certain specified subjects, Including, so far as is here relevant, "safeguards in respect of the financial responsibility of members." Section 8 (b) of the Act requires members of national securities exchanges and other brokers doing business through members to establish and maintain their capital within such minimum relationship to their indebtedness as the Commission's rules may prescribe. Section 8 (c) prohibits members of national securities exchanges or brokers or dealers doing a business through members, from rehypothecating or commingling their customers' securities in certain circumstances if in contravention of rules and regulations which that section authorizes the Commission to adopt. Section 15 (c) prohibits all brokers and dealers from using the mails or instrumentalities of interstate commerce to effect transactions in the over the counter market in contravention of rules and regulations of the Commission with respect to the financial responsibility of such brokers and dealers. By Section 17 (a) the Commission is empowered to require the making, keeping, and preservation on the part of all members of exchanges and of brokers and dealers registered with the Commission, of such accounts, books, and records, as the Commission may prescribe by regulation as necessary or appropriate.]

A. The Commission therefore proposes to issue rules and regulations establishing the same 15 to 1 ratio between a broker's indebtedness and his capital as is proposed by the New York Stock Exchange; and it will make appropriate definition of the terms "aggregate indebtedness" and "net capital" for the purposes of the regulation.

B. Regulations under Section 8 (c) of the Act will prohibit rehypothecation of customers' safekeeping securities, limit the extent to which customers' margin securities may be repledged, and place restrictions on the commingling of customers' securities.

C. The Commission will also promulgate rules requiring the keeping and preservation of books and records essential to the proper conduct of a brokerage business.

D. The Commission is of the opinion that full realization of effective regulation of the industry in the public interest is to be found in the establishment of trust institutions to assume the banking and custodial functions of the brokerage business. Only such a system (hereafter described more fully) can be an adequate substitute for direct governmental supervision and control. Pending the establishment and full operation of trust institutions, no measure of protection can be overlooked. The machinery which the New York Stock Exchange will set up for the voluntary separation by its members of their brokerage and dealer businesses through the formation of separate corporate affiliates to handle their dealer and underwriting activities has constructive possibilities in this direction if properly encouraged by the Exchange. The Commission views the full development of this plan as an essential of interim regulation, and it is hopeful that such measures as these will prove to be an appropriate area for regulation by the industry rather than for further and additional regulation by government.

These combined proposals represent a program well balanced between regulation by the industry itself and regulation by the Commission. And the principles which underlie these various proposals rest upon a sound basis, since they undertake to deal with the problems arising from the broker dealer and the broker-banker combinations.

THE BANKING ASPECTS OF BROKERAGE

The broker (both on an exchange and over-the-counter) who does a margin business performs a banking function at least equal in importance to his brokerage services. Yet, so well accepted in the practice of including banking accommodations along with brokerage service, that custom has obscured the full significance of the banking function performed.

Many activities regarded as incidental to the brokerage business are in reality banking activities. The broker loans money to margin purchasers from his own funds, retaining the purchased securities as collateral for the loan. He makes similar loans with funds obtained from banks. Just us banks receive cash deposits, so the broker receives and retains cash, or "free credit," balances for the account of customers, and, in the manner of a bank, makes loans from such funds. An increasing tendency on the part of customers to leave their fully paid for securities with their brokers for safekeeping, as well as securities which constitute excess collateral not needed to secure the customers' margin accounts, has resulted in the assumption by brokers of custodial functions traditionally performed by the banks or trust companies.

The banking business done by brokers involves hundreds of millions of dollars. As of August 31, 1938, member firms of the New York Stock Exchange alone held deposits of customers' cash in the form of free credit balances aggregating approximately $272,000,000. As of the same date, the total market value of securities held in margin accounts carried by New York Stock Exchange brokers has been estimated at more than $2,000,000,000. [Footnote: As of the end of August 1938, bank borrowings by member firms of the New York Stock Exchange aggregated approximately $570,000,000 while the total of their loans to customers was approximately $865,000,000. During the rising market in the spring of 1937 these figures reached a total of $1,215,000,000 for broker's borrowings and $1,559,000,000 for the total of brokers' loans to customers.] Loans to customers by New York Stock Exchange brokers have in the recent past regularly aggregated in the neighborhood of a billion dollars. The total market value of all customers' fully-paid or excess collateral securities held by all brokers is not yet definitely known. Nevertheless, it has been conservatively estimated to be many times greater than the amount of customers' free credit balances.

This banking business, carried on not only by many members of exchanges, but also by those engaged in the business of buying and selling securities in other markets as well, is neither regulated nor supervised as a banking business by the Government, State or Federal. Its supervision has been left in the hands of the exchanges. The deficiencies in the system in vogue under the old regime of the New York Stock Exchange have been noted. In spite of such deficiencies, however, the record of stock exchange houses in terms of financial failures has been remarkably good. Yet the objective here is that of supplying further and more adequate safeguards so that inherent financial risks will be further minimized. Furthermore, we have seen instances in which the handling of customers' securities has been both lax and in disregard of the ordinary standards of trusteeship. Customers' free or excess collateral securities have not always been kept segregated from the securities of the firm or its partners, or from securities held on margin for other customers. The use by brokers of these customers' securities to collateralize their own business loans in an effort to tide themselves over a crisis comes to light only in such cases as that of Richard Whitney, where failure of the effort resulted in its detection. Furthermore, despite exchange rules to the contrary, margin securities of customers have been rehypothecated with banks in excessive amounts which bear no relation to customers' indebtedness to the broker or have been so commingled with the securities of the firm or its partners or those of other customers us to subject their owners to unjustifiable hazards.

Customers' free credit, balances have been regularly subjected to even greater hazards. Evidence adduced in the Whitney case indicates that it has been the usual practice among brokers to commingle customers' funds with those of the firm and to use them for whatever the daily demands of the business may require. The cash balances of member firms of the New York Stork Exchange have normally been far below the total amount of customers' free credit balances -- the customers' cash held and used by the brokers.

[Footnote: Abstract from reports of New York Stock Exchange member firms to the Federal Reserve board showing the relation between total cash on hand and in banks and customer's free credit balances:

Date: Aug. 31, 1938
Number of firms reporting: 388
Cash on hand and in banks: $200,001,000
Free credit balances: $272,100,000
Excess of free credit balances over cash on hand and in banks: $72,099,000

Date: June 30, 1938
Number of firms reporting: 389
Cash on hand and in banks: $215,894,000

Free credit balances: $257,999,000
Excess of free credit balances over cash on hand and in banks: $43,105,000

Date: Dec. 31, 1937
Number of firms reporting: 415
Cash on hand and in banks: $231,546,000
Free credit balances: $277,840,000
Excess of free credit balances over cash on hand and in banks: $46,294,000

Date: June 30, 1937
Number of firms reporting: 423
Cash on hand and in banks: $214,273,000
Free credit balances: $265,715,000
Excess of free credit balances over cash on hand and in banks: $51,442,000

Date: Dec. 31, 1936
Number of firms reporting: 418
Cash on hand and in banks: $248,962,000
Free credit balances: $342,175,000
Excess of free credit balances over cash on hand and in banks: $93,213,000

Date: June 30, 1936
Number of firms reporting: 420
Cash on hand and in banks: $219,052,000
Free credit balances: $276,107,000
Excess of free credit balances over cash on hand and in banks: $57,045,000]

The risks to customers inherent in the merging of a banking business with the agency functions of a broker will always be accentuated where there is absent any real financial supervision. Yet in the conduct of those activities by brokers generally, there has been little supervision of a character comparable to that exercised over banks and the brokers are not subjected by public authority to banking standards or requirements.

THE BROKER'S BUSINESS AS DEALER

Some exchange houses do nothing but a brokerage business. More frequently, however, brokerage houses also trade for their own account and engage in the underwriting business. This combination of functions obviously entails certain risks. As we have earlier said:

"In addition to executing brokerage orders for customers, commission houses may perform a diversity of functions. They may act as principals in underwritings, in the primary and secondary distribution of securities, and in trading operations for firm account. They may serve as fiduciaries in furnishing investment advice to customers, in conducting discretionary accounts and in managing investment trusts. These interrelationships may be further complicated when such firms extend credit to their customers, hold customers' securities in pledge or hold customers' free funds on deposit; or when partners of such firms trade for their own account or act as directors or officers of corporations whose securities are listed on exchanges.

"The financial interests of a commission house, the activities of which are thus diversified, may run counter to the best interests of those for whom it acts as agent. Such a commission house may solicit brokerage customers to purchase securities which it has underwritten or is distributing or in which it has a position or an option. In furnishing investment advice, its recommendations may be colored by its security commitments. It may sell its own securities to accounts over which it has discretion. Substantial participation in underwriting or distributing operations or excessive trading for its own account may impair the solvency of a firm, thereby jeopardizing the securities, equities, and credit balances of customers. A commission house managing an investment trust may use the trust as an out let for issues which the firm has underwritten or is distributing; or it may employ the buying power of the trust to maintain the price of such issues.

"Undoubtedly, abuses incident to these multiple relationships are held in check by the standards of business conduct prevailing among reputable commission brokers. Practices on the part of a commission house which are detrimental to the interests of its brokerage customers would appear, in the final analysis, to be opposed to the dictates of enlightened self-interest. Nevertheless, such abuses have not been uncommon in the past." [Footnote: See pp. 3-4, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, Securities and Exchange Commission. (June 20, 1936). The similar abuses in the over-the-counter securities markets which may result from combining broker and dealer activity are reviewed at p. 75 of the same Report.]

But at this point we are concerned only with the manner in which the dealer functions increase the financial risks of the unregulated banking business. The problems of conflicting interests in the furnishing of investment advice, the handling of discretionary and investment trust accounts, and other like activities, which are raised by the presence of the combined broker-dealer function are not here dealt with. Nor do we deal with the conflict between a dealer's self interest and a broker's duty to his customer as it may exist in the case of specialists and others on the floors of exchanges.

Speculation by brokers or brokerage firms for their own account us well as their purchase of blocks of securities for primary or secondary distribution -- a common cause of brokerage failures -- directly threaten the brokers' capital essential to the safe handling of their customers' affairs, funds, and securities. Theft and embezzlement of customers' funds or securities usually have been but the aftermath of a course of over-extension and over-commitment invited by permitting brokers to engage in trading or underwriting activities for their own account.

As we have said, however, in spite of the risks to customers inherent in the combination of brokerage, banking, and dealer functions, the record of exchange houses in terms of financial failures has been an exceptionally good one. Yet the impact on the public, and on the exchange members themselves, of those financial failures which have occurred has been serious.

REGULATION OF BANKING AND DEALER ASPECTS OF BROKERAGE BUSINESS

The program set forth above makes a significant advance on these problems of financial risks arising from a combination of banking and dealer functions with those of a broker. Further steps to the same end can and should be accomplished either by additional legislation, by administrative regulation, or by regulation and control by the industry itself. Regulation by the industry, if given adequate time to make the basic readjustments necessary, could effectively separate the banking and the brokerage functions so us to produce a more efficient and effective system.

One method of accomplishing this could be a self-imposed requirement that firms deposit customers' free credit balances in trust accounts separate from those of the firm and that customers' fully paid or excess collateral securities be deposited either in a central depository similar to the one proposed by the New York Stock Exchange, or held in trust account. If that system were followed, free credit balances would not be subject to any liens in favor of the depository bank to secure its own loans to the broker, or to the claims of general creditors of the firm. Nor would they be permitted to be commingled with the funds of the firm or its partners. Under that system, separate deposit of customers' fully paid or excess collateral securities would relieve a broker of responsibility for them, would regularize the methods of handling such accounts, and would afford the public greater protection than it has enjoyed in the past.

But it is our view that the ideally effective measure for dealing with customers' free credit balances and customers' fully paid or excess collateral securities would be the establishment of trust institutions in various financial centers. The establishment of a separate trust institution for these purposes was a suggestion originally advanced by various members of the New York Stock Exchange. Such an institution would assume all banking and custodial functions now performed by brokers as an incident to their brokerage business whether conducted on a cash or on a margin basis. It would be established under national or state banking laws. It would be subject to the same supervision and control us is now exercised over national and state banks and trust companies. Establishment of such trust institutions in the leading financial centers would be the most effective means of accomplishing a separation of banking functions from brokerage functions. Institutions of this character would have the advantage of placing centralized banking activities under appropriate supervision, reducing to a minimum financial risks to customers, and lessening the overhead expenses of individual brokers. Their use would also serve to remove customers' cash and securities from the risks of insolvency involved in the combination of the dealer with the brokerage function. Of equal importance would be the ability of trust institutions to protect customers from that confusion of conflicting and rival creditors' claims which follows the failure of a modern brokerage firm. Trust institutions could so operate that customers' rights might be realized without the difficulties and expenses which now result from the intricacy and costs of legal proceedings to wind up an insolvent brokerage house.

It is recognized that such a plan might not lend itself to immediate consummation. And exploration of the feasibility of the system proposed has, it is true, disclosed divergent points of view. Those who doubt its practicability point to the multitudinous accounts requiring banking service; the volume of cash balances and safekeeping items; the types of service demanded by customers in connect in with the latter; the expense of the initial organization of such an institution and the resistance which might be met in both banking and brokerage circles. Nevertheless if is our considered judgment that such a plan contains the desirable ingredients of self-determination on the part of the brokerage community as against direct governmental action requiring the separation of the banking and brokerage functions. Finally, trust institutions would, by their own safeguards, obviate the need for much of the program of present and future regulation on the part of the industry and government discussed in this Report. This program of regulation will necessarily be complex since it is required by the very complexities which have resulted from the combination of banking and dealer activities with the brokerage business. It will also in some respects be unavoidably burdensome. Hence, it would be eminently desirable, from all points of view, if this multiplicity of regulation could be dispensed with as a result of the separation of functions by means of trust institutions to conduct the banking activities of brokers.