

Regional Administrators  
File

SUMMARY OF DISCUSSIONS ON MAY 4 AND 5, 1954

AT REGIONAL ADMINISTRATORS CONFERENCE

The following is a summary of the discussions relating to the cooperative inspection scheduling program, the proposed inspection manual, Rule X-17A-5 reports, etc. prepared by Mrs. Murphy from notes taken by her during these meetings.

SUMMARY OF CONFERENCES ON MAY 4 and 5, 1954

Commissioner Adams Presiding

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When the conference with the Over-the-Counter Branch of the Division of Trading and Exchanges opened on May 4, 1954, Commissioner Adams stated that the first matter to be discussed was the cooperative program for scheduling broker-dealer inspections. He referred to his memorandum of March 10, 1954, to all Regional Administrators re Scheduling and Co-ordination of Broker-Dealer inspections. Broadly stated, the program is intended to avoid several inspections or examinations by different parties of a particular firm in a short period of time, and the situation where a firm remains uninspected for a substantial period of time even though subject to several different inspecting or examining parties. The program is based on an interchange of information of inspections by cooperating parties so that any such party can find out when, and by whom, a particular firm was last inspected (but the findings of an inspection are not to be exchanged). The program is concerned only with routine inspections and, in theory, each cooperating party would agree, although with some exceptions to be noted later, not to undertake a routine inspection of a particular firm within say six months of an inspection by another cooperating party. It is to be stressed that the program is concerned solely with routine inspections and should not restrict any inspection or inquiry for good cause. He said that for the past several years our inspection program has been criticized by Congress and it has been suggested that we let the States do the inspecting. The Commission

knew that few States were equipped to undertake broad inspection programs and believed that the best solution was a cooperative inspection scheduling program by all regulatory bodies. It, therefore, entered into negotiations to formulate such a program with the State Securities Administrators, the NASD, and the stock exchanges. When Commissioner Adams discussed the matter at a meeting of the National Association of Securities Administrators last year, that Association appointed a Committee headed by Mr. John F. Hueni of Michigan to work with the SEC. This Committee made a survey to ascertain which State Administrators have legal authority to make inspections and what type of program they had for inspecting brokers and dealers. (The Committee's report was distributed to the Regional Administrators. A copy is attached.)

Commissioner Adams asked the Regional Administrators to report what they knew about the inspection work done by the States in their regions.

Mr. Green, Atlanta, advised that the States in his region are not equipped to make inspections. In Alabama the brokers and dealers are under the jurisdiction of The Attorney General who has designated a lawyer to handle matters pertaining to them. In Georgia jurisdiction over brokers and dealers is in the office of the Secretary of State where a woman employee handles their matters. Florida has an active Securities Commissioner but he can inspect only when he has reason to think something is wrong, and it is the only State in Mr. Green's region that can be said to be at all equipped to make inspections. North and South Carolina have no personnel to do inspections. In reply to a question by Commissioner Adams, Mr. Green said he did not think any of the Southern States would or could get additional money to hire inspectors. He said that there is close

cooperation between his office and the States.

Mr. Hoopman, speaking for the New York Office, said he had not heard from the States in his region and does not know whether they are scheduling inspections. The report of the Committee mentioned above shows that New York and New Jersey do not "license" brokers and dealers and that while Pennsylvania can inspect the Securities Commission has only one part-time examiner and made no complete inspections in 1953.

Mr. Cohn, Denver, advised that he wrote to the authorities of the States in his region with regard to the program and has heard from four of them. They will cooperate but do not have money or personnel for an inspection program. He said that Nebraska makes an inspection upon receipt of a complaint.

Mr. Kendrick, Boston, reported that Maine and Massachusetts do not make inspections. The Connecticut Securities Commission has invited him to Hartford to discuss the program on June 14.

Mr. Newton, Seattle, said Washington has no means of making inspections although sometimes it will inspect upon receipt of a complaint. Idaho is about to amend its "blue sky" law and may be able to inspect in the future.

Mr. Orrick, San Francisco, advised that California inspects only upon complaint. It made 38 inspections in 1953. No inspections were made by Arizona and Nevada in 1953.

Mr. Hart, Chicago, said that the States in his area are cooperating. Michigan has furnished him with a list of inspections made in 1953 and through April 15, 1954. Wisconsin has also furnished him

with a similar list. This State checks particularly for insolvency and churning.

Mr. Allred, Fort Worth, informed the conference that none of the States in his region has an inspection program. He and the Texas Commissioner frequently discuss matters of interest to both.

Commissioner Adams said that cooperation with State agencies was highly desirable and that it was in line with the Administration's policy. He urged the Regional Offices to consult freely with state agencies.

Mr. Purcell said that he agreed with Commissioner Adams and that he had referred to the New York Attorney General certain cases where fraud was involved. He expressed the hope, however, that something could be worked out whereby proper credit would be given to the work done by the S.E.C. in any publicity following action taken by the state. He referred to one case in which the New York Attorney General had taken action after Mr. Purcell had referred to him the results of an investigation made in the New York Office. The publicity which followed the injunction entered in the state court on the Attorney General's complaint made scant reference to the cooperation of the work of the S.E.C. and no mention of the fact that the Attorney General had commenced the action as the result of information supplied by Mr. Purcell and his staff. Commissioner Adams said that some time he would discuss the matter with Mr. Goldstein.

Mr. Newton reported three instances in his area where the state could not get indictments, but later the S.E.C. stepped in and, upon reference to the Department of Justice, convictions resulted.

Commissioner Adams commented that we should encourage and help state commissions to be strong and effective and that when a matter is

turned over to a state the Regional Administrator should keep an eye on it to see what happens and report the results to the Commission.

Commissioner Adams also asked the Regional Administrators to state what they know about the NASD inspection program in their regions.

Mr. Newton asked what the NASD is supposed to do in its inspections. Mr. Keenan replied that NASD examinations are not comparable to exchange examinations or S.E.C. inspections. Exchange examinations are aimed primarily at financial conditions and customers securities including safekeeping items, while NASD examinations look first at pricing practices and churning and secondly at books and records, hypothecation, etc., but with little attention to financial condition. It was agreed that S.E.C. inspections were much more comprehensive than similar examination work by other parties. NASD reports are of the check sheet variety, not the essay type. The report goes to a local committee familiar in general with the business of the inspected firm. A comment was made that, after all, the NASD inspector was in effect examining his own employer.

Mr. Cohn said that his inspectors had followed an NASD inspector on one occasion and they reported that the NASD inspection was similar to ours. He believes, therefore, that the procedures must vary from region to region. Commissioner Adams remarked that they should not since they are directed from Washington. Mr. Purcell said he understands the NASD inspects only the over-the-counter transactions of stock exchange firms. Miss Steig said that the NASD has referred solvency cases to us

so it must make some financial inspections. Mr. Hart said he thinks the inspections will be as good as the men doing them and that in the Chicago area the NASD has three good men.

Mr. Green asked whether we had to wait six months after the NASD had made an inspection and said if we did, our inspections would be very expensive, because inspectors would have to return to a city several times. Miss Steig said that we would not be precluded from making an inspection within a short time after the NASD had if we had reason to think we should. Mr. Adams reiterated that we do not want to subject brokers and dealers to successive inspections by various authorities within a short period of time.

Mr. Green said that the NASD inspected 8 of the largest firms in Nashville in 8 days and it appeared to him that their inspections are more in the nature of visits. The inspectors ask the firms for information rather than find it for themselves.

Mr. Hoopman reported that the NASD had communicated with him but he did not go into details. He added that he does not get any advance information from the NASD representative in New York but had received such information from the one in Pennsylvania.

Mr. Newton said he heard of a case where a firm was inspected by the NASD and declared to be O. K., and he wondered whether the NASD was making such thorough inspections that they could put an O. K. stamp on the firm.

There was considerable discussion whether information concerning prior inspections should be given to the NASD or other cooperating agencies without some assurance that such information was requested in contemplation of early inspection. Mr. Orrick reported that when the program was announced the NASD obtained from him information re prior inspections of twenty-five brokers and dealers and inspected all of them within a short time. Mr. Kendrick said that on three occasions the NASD had made similar requests covering about ten names each and that he knew that they had not inspected all of them. Mr. Hart said that the NASD representative requested similar information from him concerning a number of brokers and dealers, but he asked the direct question whether they were to be inspected and when told that they would be he made a note on his records of the date on which the information was furnished. It was pointed out that Mr. Hart's direct question appeared to eliminate any uncertainty as to the purpose for which the information was requested. Commissioner Adams then asked the Regional Administrators whether they wanted to know in advance what inspections the NASD intended to make in the reasonably near future. All Regional Administrators said they would. Commissioner Adams said he would consider taking the matter up with Mr. Fulton.

On the question of cooperation by the stock exchanges in scheduling inspections, Mr. Keenan stated that the New York Stock Exchange is committed to a program of inspections to which it must adhere. In answer to a question as to which exchange would inspect a firm which is a member of one or more, Mr. Keenan said that all would waive jurisdiction first to the New York Stock Exchange then to the American Stock Exchange and next to the Midwest Stock Exchange.



It was the consensus that we should be meticulous in using the word "inspections" to describe what our inspectors do, so that the public will not think we make financial audits.

Mr. Hart said he wondered about the success of the program because we do not know whether the cooperating agencies are doing an acceptable job. Commissioner Adams commented that we must give the program a good try but at the same time we should explore the question whether the other agencies are doing an acceptable job.

Miss Steig advised the Regional Administrators that during the past year the Commission has not referred any cases to the NASD and Commissioner Adams added that this was because several commissioners feel such action may not be proper since the cases may come back to them for review of the action taken by the NASD. No definite decision in the matter has yet been made. Commissioner Adams asked for an expression of opinion as to whether the practice of referring matters to NASD should be continued. Mr. Kelly said he was in favor of continuing the old practice and the other Regional Administrators agreed with him. Mr. Hart commented that not all cases would come back for review. Mr. Keenan said that to his knowledge the Commission had been asked to review the action of the NASD in only one referred case. The Regional Administrators unanimously voted to recommend to the Commission that the old practice of referring matters to the NASD be continued.

At the opening of the afternoon session, Commissioner Adams said we would digress from the program and consider whether certain problems

are being handled uniformly. The first one was whether a sole-proprietor is required to show his non-business liabilities on his report under Rule X-17A-5. Miss Steig stated that the Division's position is that non-business liabilities must be disclosed if they would materially affect his net worth and cited Part II, Paragraph (e) of Form X-17A-5 as the authority. Mr. Cohn said one of his inspectors thought he had received conflicting opinions on the subject, but Mr. Cohn thought the difficulty arose over the question of what is a non-business liability.

All Regional Administrators and Earle King agreed with the opinion expressed by Miss Steig.

The next question was whether all assets of a sole-proprietor must be shown in his financial report. Miss Steig said that the rule has been interpreted to <sup>require</sup> disclosure of only the assets which are identified with his securities business but if the report indicated non-compliance with the capital rule his outside assets would have a bearing. Mr. King and the Regional Administrators concurred in this opinion.

The treatment of mortgages on real estate of a sole-proprietor (a home for instance) was next discussed. The consensus was that, if the mortgage indebtedness would materially affect the net worth of the proprietor's business as reflected by the X-17A-5 report, such indebtedness would have to be disclosed pursuant to paragraph (e) of Part II of Form X-17A-5 and in such cases both the asset value of the real estate and the mortgage should be disclosed thereon. The reason for this is that the equity in the real estate would be excluded from the assets in the computation of net capital under X-15C3-1.

On the question of uniformity of treatment of life insurance, the Regional Administrators were agreed that the cash surrender value of the insurance may be shown and included in net capital if it is available to the business. Mr. King advised that according to present accountancy theory insurance is not a quick asset and should not be included, but it was agreed that where an insurance policy is pledged as collateral for a "business" loan the cash surrender value would be included in net capital and the loan itself would be part of aggregate indebtedness.

Mr. Cohn then raised the question whether all securities transactions of a sole proprietor must go through his books. Everyone thought they must and Mr. Green cited as authority the Commission's opinion in the latest Leeb case. Mr. Kendrick reported a case in his region where a sole proprietor kept a private ledger of his personal transactions but made it available to our inspectors. Mr. King agreed this was not objectionable, but said that our position should be that he keep one set of books for all securities transactions whether they were effected for firm trading account or for a so-called personal account.

In connection with the difficulties encountered in sole proprietorships Mr. King advised the conference of an article in the current issue of the "Journal of Accountancy" on the question whether an accountant could certify to a sole proprietor's report. Commissioner

Adams asked Mr. King to furnish copies to the Regional Administrators.

Another question was whether a sole proprietor would be required to file a certified report if he held securities for members of his immediate family. The conference seemed to think he would. However, the facts in any particular situation might be such that the administrator would recommend that the question of requiring a certified report should not be raised.

The last discussion related to the question whether real estate bonds having no quoted market should always be excluded from net capital, since an injustice might sometimes follow. It was suggested that the ultimate test might be whether the facts of a given case would justify injunctive or administrative action for failure to comply with the capital requirements.

The next matter was a review of the Canadian situation (the Regional Administrators received the attached up-to-date summary of the applications filed by Canadian brokers-dealers and what happened to them), and the general background of the registration of Canadian brokers and dealers commencing in March, 1953, emphasizing the helpful cooperation of Mr. Lennox of the Ontario Securities Commission, who furnished us with information regarding these broker-dealers and their principals.

In answer to an inquiry, Commissioner Adams said that an inspection program for Canadians is under consideration and that the matter will have to be discussed with the State Department.

Commissioner Adams told the conference that we had recently obtained the first indictment of Canadian residents since the approval of the extradition treaty and that we shall try to extradite.

Mr. Purcell asked that the duplicate files of Canadians, who have branch offices in his region, be sent to him. This will be done.

The conference then discussed the so-called restrictive black list of Canadian issues which we found were sold in this country without registration. At the NASD's suggestion we started publishing this black list several years ago but had recently suspended it, pending study. Mr. Purcell said brokers and dealers in his area wanted the black list continued since it furnished them with some measure of protection. Mr. Purcell advised the conference that Merrill Lynch and Francis I. DuPont have their own lists which are based on information received from their Canadian branches and correspondents, and said that these firms will not effect transactions in securities on their lists, but that other brokers and dealers who do not have the information available will handle the transactions. Mr. Purcell thought he could arrange to have Merrill Lynch furnish information relative to primary and secondary distributions of Canadian issues to a member of his staff who would see that spot announcements respecting them are put on the broad tape. Commissioner Adams said that he thought this would be dangerous since we would be broadcasting unverified information. He said that he opposed the black list because issues are not put on it until after they have been sold and the damage done.

Commissioner Adams thought that possibly the matter could be approached from the direction of the responsibility of the Canadian broker-dealer aiding and abetting in a violation. He also suggested that possibly the Ontario Securities Commission would issue a directive in the matter.

Commissioner Adams asked the Regional Administrators whether they were in favor of reviving the black list. Messrs. Allred, Hart, Kelly, Kendrick, Newton and Purcell said it should be continued since it was better than nothing. Mr. Green and Mr. Cohn said they had not had any experience with it.

The next order of business was the discussion of a proposed inspection manual, a copy of which had been given to each Regional Administrator. Miss Steig explained that when the manual was discussed with the Commission, the desirability of some items was questioned, and that Commissioner Adams would undoubtedly wish to have the view of the Administrators on the manual as a whole.

First, however, Mr. King was asked to speak about financial examinations in general. Mr. King's first comment was that we must meticulously avoid the use of the term "audit." We should adopt the term "financial examinations." He then spoke of the necessity of using our inspectors in likely trouble spots. He said that he groups brokers and dealers according to these classifications:

1. Members of large exchanges.
2. Members of small exchanges.
3. Those who file certified reports because of our requirements. These registrants are again divided according to the type of accountants who do the certifying.
4. Those who file uncertified reports.

Except for cause, he would not make "financial examinations" of firms in groups (1.) and (2.), or those in group (3.) whose reports are certified by members of the American Institute of Accountants. So far as financial examinations are concerned, he would use our personnel first on those brokers and dealers whose reports are not certified, next on those whose reports are certified by public accountants and, then on those whose reports are certified by C.P.A.'s who are not members of the Institute.

Mr. Purcell interrupted to say that many brokers and dealers in his region do not keep proper books and records and that this failure on their part causes our inspectors to spend more time than they should on an inspection. He asked Commissioner Adams what he thought the policy of the Commission would be with respect to instituting proceedings to revoke for violations of Rule X-17A-3. Commissioner Adams replied that he would not hesitate to "crack down" on such violators. Mr. Green suggested that the NASD issue a bulletin on the subject.

After Mr. King's remarks Miss Steig explained that the proposed manual related to routine inspections, since limited inspections are generally concerned with isolated or special matters, sometimes as a result of complaint or rumor.

Commissioner Adams suggested that the manual be discussed item by item.

#### PART I - GENERAL INSTRUCTIONS AND DEFINITIONS

There were no questions with respect to Part I of the manual except Item 3B which states that the initial inspection shall be routine and in the case of a newly registered firm it shall be made within one year from the date of registration. Miss Steig reported that Commissioner Goodwin thought it should be made within six months, although we might have personnel and travel problems if we attempted to inspect all newly registered broker-dealers within six months after registration. It was the consensus of the meeting that these inspections should be made within six months if possible and in any case within one year.

#### PART II - PROCEDURES FOR ROUTINE INSPECTIONS

##### SECTION I - GENERAL

Item A - Pre-inspection review of Commission records pertaining to registrant.  
Page 6

This item sets forth what the inspector is to do prior to starting out on the inspections. It was brought out that these procedures are necessary and are now being followed by the inspectors in all regional offices.

Item B - Regional Administrator's instructions to inspector re financial  
Page 6  
examination.

It was the consensus that Regional Administrators should instruct the inspector as to the scope of the inspection but with the qualification



that if the inspector believes a financial examination is necessary he should make it regardless of the fact that his instructions did not specifically include such an examination.

Item C - Inspector's authority to discuss pertinent matters with registrant.  
Page 6

There was much discussion that this item was too limited. It was the feeling of the Regional Administrators that the inspectors should be authorized to discuss all matters except novel or intricate problems which would require legal or policy determinations.

Item D - Scope of test checks.  
Page 6

Appropriate and satisfactory.

Item E - Period to be covered in inspection.  
Page 7

Satisfactory after it was explained that the time limits given were intended to be flexible and that the inspector must use discretion.

Item F - Working papers.  
Page 7

Appropriate and satisfactory.

## SECTION II - INSPECTION PROCEDURES

Item A - Review of registration application with registrant, looking to  
Page 7

amendment if necessary.

Appropriate and satisfactory.

Item B (a) - Directorships (in corporations whose stock is publicly traded)  
Page 7

held by principals of registrant.

It was the consensus that this item should be reworded to make clear that the information as to directorships was incident to Rule X-15C1-5 and the disclosures required thereby. It was also the consensus that, reworded, the item is appropriate and necessary.

Item B(b) - Borrowed funds in sole proprietor's capital.  
Page 7

It was the consensus that this item is appropriate but that the word "determine" is too strong since it is not intended that the inspector arrive at a final conclusion. It was decided to change this word to "inquire" or some similar term.

(It was likewise decided to make a similar change in other items where the word "determine" is used. This decision will not be repeated in this summary under each of the items involved.)

Item B (c) Payment of dividends out of capital by a corporate registrant.  
Page 7

It was the recommendation of all that this item be omitted since it was their opinion that the inspector cannot ordinarily ascertain whether dividends had been paid out of capital, capital surplus, or paid-in surplus. Moreover, the case in which this is done is rare. However, it was the consensus that it would be important to try to obtain this information in connection with Item II H (P.11) where the registrant is selling its own stock to the public.

Item C Names of certain classes of employees.  
Page 8

Appropriate and necessary.

Item D General Business practices.  
Page 8

Appropriate and necessary.

Item E Pricing Practices  
Page 9

This item evoked considerable discussion. Miss Steig suggested that the procedure covered by the item might be eliminated, on the basis of a calculated risk, when the NASD had inspected a firm within six months or some appropriate period

prior to an S.E.C. inspection. The consensus was against any such proposal. After further discussion, Commissioner Adams asked again whether pricing practices could not be left to the NASD so far as its members are concerned. Several Administrators indicated that they would want to be free to test pricing practices but not obliged to do so in each inspection, that the SEC should not abandon price testing and leave it solely to the NASD as to NASD members. Commissioner Adams indicated that this ultimately would be a policy question and that he would discuss the matter further with the Commission. One of the Administrators said that he would, of course, follow instructions but that he would be "grieved about it".

Item F            Secret Profits  
Page 10            Appropriate and necessary.

Item G            Churning, Switching and Excessive trading.  
Page 10            The discussion here was substantially the same as in E above, with the same recommendation that Regional Administrators be free to make appropriate tests but not obliged to do so in every inspection.

Item H            Transactions by firm and management in own securities.  
Page 11            Appropriate and necessary. Moreover, it was the consensus that inquiry re payment of dividends out of capital (see Item B(c) above) should be made where registrant is selling its own stock to the public.

Item I            Trading by insiders of firm and issuer.  
Page 11            Reconsider.

Item J  
Page 12

Sec. 16 - Trading by insiders

It was urged that this procedure should be omitted because (1) it was impractical to make an independent check and we would have to rely on what the broker-dealer said and (2) nothing was gained or lost by it.

Item K  
Page 12

Underwritings and Distributions

(a) Appropriate and necessary to inquire as to distributions.

(b) It was urged that this item be reworded to clarify and sharpen it by spelling out that the procedure seeks to ascertain whether distributions were made under a registration statement, a Regulation A, or a Regulation D filing.

(c) Appropriate and necessary to inquire as to extension of credit on security during distribution.

(d) It was urged that this item be reworded to ascertain whether the registrant traded in securities prior to as well as during a public offering of securities of same issuer.

Item L  
Page 13

Borrowing of securities (Sec. 8(d) SEA)

Appropriate and necessary.

Item M  
Page 13

Rules

Rules X-10A-1 and X-10A-2 - Short Selling

It was urged that this item be reworded to make it clear that it concerns a check regarding the marking "long" or "short" of all sell orders for exchange execution.

Rule X-17A-5 Financial Reports  
Page 13

(a) Certification

It was decided to reword clause (1) in this item so as to

permit the inspector to satisfy himself whether the firm is required to file a certified report with an agency of a state or a securities exchange.

(b) Reconciling X-17A-5 report.

There was much discussion re this item which states that when it appears desirable or necessary the inspector must check the registrant's most recent X-17A-5 report against its books and records as of the date of the report. Mr. King said he thinks this procedure is necessary in every case where an uncertified report was filed. He thinks it would be sufficient for the inspector to ask the registrant for the trial balance as of the date of the report and check it against the report. If it does not agree with the report, he should go further into the matter. The Regional Administrators felt that this check should not be mandatory but simply authorized. Mr. King feels strongly that it should be mandatory and asked for permission to argue the point again before the question is decided.

This item further states that if it is found necessary to communicate with the accountant who certified the report under Rule X-17A-5, the inspector must first obtain permission and instructions from the Regional Administrator. All the Regional Administrators felt that the inspector should have authority to talk to accountants without first getting permission. Commissioner Adams said this part of the item would be reconsidered.

(c) Independence of accountant.

The Regional Administrators had no questions about this, but Mr. King suggested that the inspector also check to ascertain whether the certifying accountant is qualified to act in the State in which he is practicing. Qualification as used by King does not mean competency. It was decided to reword this item to include his suggestion.

(d) Detection of forged and fictitious reports.

Appropriate and necessary.

Rule X-17A-3 - Books and records.

P. 15

Appropriate and necessary.

Rule X-17A-4 - Preservation of books and records

P. 15

Appropriate and necessary.

Rules X-15C2-1 and X-8C-1 - Hypothecation

P. 16

Appropriate and necessary.

Rule X-15C1-4 - Confirmation

P. 17

Appropriate and necessary.

Rule X-15C1-5 - Disclosure of controlling relationships.

P. 17

Appropriate and necessary.

Rule X-15C1-6 - Disclosure of financial interest in distributions.

P. 17

Appropriate and necessary.

Rule X-15C1-7 - Discretionary accounts, excessive trading.

P. 17

Appropriate and necessary.

Rule X-15C1-8 - Distributions at market.

P. 18

Appropriate and necessary.

Rule X-15C3-1 - Capital rule (See Item R)

P. 18

Appropriate and necessary.

Regulation T - Extension of credit.

P. 18                      Appropriate and necessary.

Item N                      -            Chandler Act.

P. 18

(a) The question was raised as to the Commission's power to act if customers' securities are not properly segregated. Some of the Regional Administrators suggested that the Commission adopt a rule requiring segregation. Commissioner Adams said the matter will be explored and he asked Miss Steig for a memo on the subject.

(b) Appropriate and necessary.

(c) Some Regional Administrators felt that inquiry re bonding of employees was inappropriate because it is strictly a management matter. Commissioner Adams, Mr. Kendrick and Mr. Purcell felt that such inquiry is important. It could be made in connection with Item D of the inspection procedures (general business practices and policies).

Item O                      -            Investment Company Act.

P. 19

Appropriate and necessary.

Item P                      -            Investment Advisers Act.

P. 19

Appropriate and necessary.

Item Q                      -            Rules of other regulatory bodies.

P. 20

It was recommended that the first sentence be reworded to read "compliance with Stock Exchange or NASD rules or laws and rules of State regulatory bodies."

Item R                      -            Rule X-15C3-1

P. 20

(a) It was recommended the words "examination for financial condition" be changed to "financial examination" or "examination for compliance with the net capital rule."

(1) It was recommended that the Manual be revised to state that the inspector could take off, or ask the broker-dealer for, a trial balance.

(2) It was the general view that inquiry to ascertain whether the firm is subject to the rule is appropriate whenever necessary or when, as Mr. Farrell said, there is no reason not to do so. The discussion re this item lead to expressions of opinion that our capital rule should be revised. Commissioner Adams said that he and Commissioner Rowen are studying the matter. He said some difficulty may be encountered in making the rule applicable to all brokers and dealers by Section 8(b) of the Securities Exchange Act of 1934. He asked what the Regional Administrators thought of a rule requiring a minimum amount of net capital expressed in dollars. Most of them thought that such a proposal would meet opposition.

(b) It was generally agreed that inquiry should be made with respect to business assets held jointly by a sole proprietor and his wife (or others) and as to non-business liabilities. It was also generally agreed that where the proprietor does not have exclusive title to business assets, such assets could not be treated as proprietary capital. However, it was pointed out that the question may turn on state law, as in community property states, and that in particular cases the problem should be considered from the enforcement angle.

(c) A Regional Administrator thought the first sentence of this item put too much of a burden on the inspector and Commissioner Adams agreed with him. It seemed to be the consensus that this sentence would be changed as suggested by Mr. King in his comments attached to the manual.



It was urged that the second sentence of this sub-paragraph be deleted. If verification of customers' accounts is required, the matter would be one of enforcement, not inspection.

### PART III

#### Reports of Routine Inspections

The Regional Administrators questioned whether the check sheet should be made a part of the report. It was also suggested that the check sheet should be revised so as to modify the requirements for "yes" or "no" answers to items relative to violations, since inspectors will not know whether there are definite violations or not. Miss Steig said we shall attempt to revise the check sheet and make it for Regional Office use only.

During this part of the discussion, certain general questions were raised, two of them with respect to computing net capital. The first was whether the commission had considered raising the 10% haircut. Commissioner Adams replied that this is being studied in connection with the revision of the net capital rule and that it was his opinion we should not allow more for securities than a bank would lend on them.

Another question referred to our policy with respect to subordinated claims. There was general opposition to treating subordinated claims of customers as capital.

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The discussion of the proposed manual was concluded Wednesday morning. A discussion of the new registration forms for broker-dealers and investment advisers had been scheduled for that day but since time

was short it was decided to pass on to more important matters. Miss Steig advised the conference that Rule X-17A-5 and Form X-17A-5 were being revised. She explained that a committee of the American Institute of Accountants was working on forms of financial reports and that, at the request of Mr. King, final revision of the above mentioned rule and form might be deferred until that committee's forms are promulgated.

She requested the Regional Administrators to forward X-17A-5 reports promptly, not later than 10 days after receipt, except during peak filing periods when this may not be possible. She said that prompt forwarding is necessary because the Commission will want to take prompt action where there is non-compliance with the net capital rule. She also advised of her recent study which revealed that only 159 out of about 3770 reports considered showed insufficient capital when computed according to Rule X-15C3-1; that in 96 of these cases the registrants were definitely not subject to the rule, while in the remaining 63 cases the registrants were or may have been subject to the rule. She requested the Regional Administrators to show on the check sheets in the space for "comments" what they did or are doing in the case of non-compliance with the rule. If they wish to make a formal report they may do so. In any respect the report must be in detail since the Commission expects the staff of the Division of Trading and Exchanges to bring to the table cases of non-compliance with Rule X-15C3-1.