SUMMARY OF DISCUSSIONS ON SEPTEMBER 26 AND 28, 1955

AT REGIONAL ADMINISTRATORS CONFERENCE

The following is a summary of the discussions relating to Reports of Investigation, References to State Authorities, Problems Presented by the R. V. Klein Decision, Special Investigations Unit, The Cooperative Inspection Program, The Inspection Manual and Report Forms, Cooperation of the Regional Administrators in Processing Broker-Dealer Applications, etc. prepared by Mrs. Murphy from notes taken during the meetings.

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CONFERENCE ON SEPTEMBER 26, 1955

COMMISSIONER PATTERSON PRESIDING

REPORTS OF INVESTIGATIONS

Commissioner Patterson opened the conference by stating that the first topic of discussion was "Reports of Investigation" and that the first item was those reports recommending formal orders. He said that no particular form of report is required but it is necessary that sufficient information be supplied so that the Commission can be advised that an adequate basis exists for the issuance of a formal order. He specified that the report should set forth the name of the security involved, the section of the Act involved, the names of the proposed respondents and their participation in the suspected violations, the period of time to be covered by the investigation, the basis for the suspected violations, the available jurisdictional basis, the officers to be named in the order and the reason why subpoena power is necessary. He also stated that it would be helpful and time saving if a draft of the proposed order were submitted as provided by Office Memorandum No. 157.

Mr. Holden explained that the foregoing information is needed in order to handle the matter intelligently and expeditously in this office. He pointed out that the Commission always asks whether we have the use of the mails or other jurisdictional elements and why subpoena power is needed. Mr. Newton asked what if we didn't have the use of the mails or other jurisdictional basis but expected

to get such evidence by the investigation. Mr. Pennekamp replied that he thought the Stardust case covered that situation. In that case the respondent defended on the ground that it had not used the mails and the court held that use of the mails was not necessary for a formal order since that may be a matter to be developed in the investigation. It was asked whether, so far as brokers and dealers are concerned, we could rely on the fact that they are registered and therefore presumed to be using the mails or instrumentalities of interstate commerce or whether we must show specific use of the mails or other means or instruments of interstate commerce. Mr. Holden replied that we must have facts indicating jurisdictional basis and not rely on presumption.

Commissioner Patterson advised that the question of delegation of subpoena power to the Regional Administrators had been studied by the General Counsel's Office which, he understands, has concluded that the Commission may delegate subpoena power but that the Commission has not yet considered the question.

Commissioner Patterson stated that the next type of reports to be discussed was those containing recommendations for injunctive action. He stated that while Office Memorandum #157 contemplates submission of a report, many cases, particularly those

based on Section 5 of the Securities Act, may be in the form of a letter, especially if it will save time. The information necessary is similar to that required for a formal order, but when court action is recommended the report must show the evidence available to prove the case. Where fraud is to be charged, the report should set forth the elements of the fraud and the proof available to establish such elements. It is also necessary that a draft of the complaint be submitted. Mr. Holden explained that we try to clear all recommendations for injunctive action with the Commission as soon as possible and that we must be able to tell the Commission how each allegation is to be established. Therefore, reports recommending injunctive action must contain such information in order to expedite clearance with the Commission. He suggested that each allegation be listed separately followed by proof, naming witnesses, etc. He repeated that time is of the essence in injunctive cases and it would expedite matters if reports recommending such action were set up as suggested.

Mr. Moran asked whether all recommendations for injunctive actions should be sent to the Division of Trading and Exchanges or whether those in which a contest is expected should be sent to the Office of the General Counsel. Mr. Holden replied that all recommendations for injunctive action should be initially sent to the Division of Trading and Exchanges, but that later if a contest develops, all documents are to be sent to the General Counsel's Office

with copy to Division of Trading and Exchanges.

Mr. Pennekamp asked whether it is necessary for the Regional Administrator in each case to seek a restraining order, temporary injunction, and a permanent injunction or whether he could skip the first two and seek a permanent injunction immediately. Mr. Holden replied that each case should be decided on the basis of the facts. He pointed out that ordinarily in an injunctive suit time is of the essence; that a restraining order or preliminary injunction can be obtained in less time than a permanent injunction. It was also pointed out that if we obtained a restraining order or preliminary injunction, violations of those orders would give us a basis for a contempt action. At this point Mr. Green stated that as a result of the C. Randall Henderson case, it is not clear to him whether the statute of limitations on contempt is 1 or 5 years. Mr. Blair replied that in that case, the court sidestepped the question stating that the contempt had taken place within a year. He said, however, that he thinks the statute of limitations is 5 years.

Commissioner Patterson then referred to those reports recommending administrative actions. Such reports set forth the facts and evidence underlying the alleged violations, the jurisdictional basis and in the conclusion cite the various sections and rules which have been violated. He said it would be helpful if the report also contained a short statement by the attorney handling the investigation as to his theory of violations. He added that the Office

of Opinion Writing advises that it would also be helpful to it if the attorney assigned to the case were to set forth the theories underlying the violationsin the proposed findings.

Mr. Gibbons led the discussion with respect to this suggestion and pointed out that while we do not need a statement from the Regional Office as to the theory of violations in obvious cases, such as embezzlement, nevertheless there are many other cases where the theory of the violations would be helpful in drafting the order for proceedings and in presenting the case to the Commission. It should be remembered that the report recommending administrative action is not a part of the record and is, therefore, not available to the Office of Opinion Writing. In order that the theory of the violations be available to the Office of Opinion Writing, it would have to be contained in the proposed findings or other document which becomes a part of the record. The Regional Office representatives appeared to feel that the present reports are sufficient and that it was not necessary to spell out the theory of violations.

At this point Mr. Green said that he would like to digress from the subject for a moment and bring up a question which is novel to him. He said that recently he had been asked to file a written answer to a motion to dismiss and he wanted to know if that procedure were not new. Mr. Gibbons replied that we made a practice of filing written answers to motions to dismiss. Mr. Green said that where there is a question of fact involved he could see the necessity for the procedure but that he didn't think an answer is necessary when the only question involved is a legal one.

Mr. Krys raised the question whether the theory of violations would be in a public document and served on opposing parties.

Mr. Gibbons repeated that he thinks the theory should be set forth in the report of investigation and then again in a public document, such as the proposed findings or brief in support of them, which is served on opposing parties.

Mr. Green said that he serves his proposed findings and briefs on opposing counsel but that the Secretary does not serve such papers from the respondent on him. Some other Regional Administrators said they were not served with such documents by the Secretary, while other Regional Administrators said that they were served. It was decided to take the matter up with the Docket Section.

Mr. Green said that he thinks the exhibits in an administrative proceeding should be left in the Regional Office for use of the parties in preparing proposed findings and not taken to Washington by the Hearing Examiner. Mr. Reid advised that in the R. H. Johnson case where there were about 2,000 exhibits the New York Regional Office kept the exhibits and asked for a departure from the Rules of Practice to permit the Regional Office to prepare and file its proposed findings and then give the respondents an opportunity to prepare theirs. This plan was followed and all parties to the proceeding were able to use the exhibits.

It was suggested that the Rules of Practice be amended to provide for filing proposed findings and brief in support of them simultaneously and to allow 20 days for filing them with an additional five days for cases in the Western part of the country. Mr. Green stated that he did not think that all parties should be required to file proposed findings and briefs within the same period. He believes that whoever has the burden of proof should be

required to file first; that the other parties should be given sufficient time thereafter to file and that the first party be allowed additional time to answer. In this way replies by each party to the other party ad infinitum would be eliminated. After much discussion it was recommended that the Rules of Practice be amended (1) to provide that proposed findings and brief be filed simultaneously and (2) to allow the following time for filing them: 20 days for the moving party; 20 days thereafter for the respondent; 10 days thereafter for the reply of the moving party, with additional time in Western cases.

Mr. Krys then asked whether there is some way whereby the respondent could be forced to answer our original plea. He did not mean an answer at a pre-trial conference which is often held on the same day the hearing is scheduled to start, but an answer in writing prior to the hearing date so that the hearing itself could be shortened. He had in mind obtaining written admissions or denials of facts so that we would not have to prove, for instance, that a broker-dealer is registered or that no filing was made under the Securities Act with respect to a particular security. One Regional Administrator thought that the federal rule pertaining to requests for admissions could be used as a guide. Mr. Reid thought that requiring an answer simply traversing allegations is old-fashioned and that we should make demand for an admission or denial of each allegation. But, he added, even though we obtain admissions, we would have to put in some evidence in order to give the Commission data on which to evaluate the case and determine the proper sanction. Mr. Moran replied that if the respondent does not admit allegations

or if his answer is not responsive, we must make out a prima facie case. Messrs. Reid and Pennekamp thought that the Commission would desire something in addition to a prima facie case by way of admissions or other evidence in order to get the feel or the appeal of the case for the purpose of determining public interest and sanction.

Mr. Blackstone thought that the Commission could get information on which to measure the sanction from sources other than the record, and he referred to the fact that courts will, before sentencing a convict, obtain information from probation officers, social workers, et al for the purpose of determining what sentence to impose. Mr. Reid remarked that in military courts there is a "record of data" made after the findings, which is used in measuring the sanction. He suggested that the Rules of Practice be revised so as to permit evidence on the question of public interest--such as expulsion from the NASD or suspension from a stock exchange--to be presented after the findings have been made. This procedure may require a supplemental hearing since the respondent should be given an opportunity to rebut such evidence. Mr. Brown said that he was surprised to know that such evidence is not presently admissible to show intent and wilfulness.

It was the consensus that the Commission should consider requiring responsive pleadings and/or requesting admissions and denials.

Commissioner Patterson then referred to Progress Reports and stated that at least every three months a report should be prepared on each open investigation by the man working on the case, which should be approved by the Regional Administrator. This makes certain that the case comes to the attention of the Regional Administrator personally at these intervals.

The report, which should be cumulative, should set forth the evidence obtained during the period, the work contemplated during the next quarter, and the estimated time before the case is completed. The evidence need not be set forth in detail, but the nature of the evidence, the number of witnesses interviewed with a classification as to whether they are principals, investors, or supporting witnesses should be shown so the Home Office file will reflect the status of the investigation. Mr. Holden said that in some cases his office has not been getting Progress Reports while in other cases the reports received did not give sufficient information to permit him to know how the case is developing and progressing. Mr. Reid said the preparation of progress reports is burdensome and Mr. Holden replied that even so, it is necessary that the Home Office know what witnesses were interviewed, what evidence was uncovered, how the case is developing and approximately how long it will be before a recommendation can be made. He pointed out that Progess Reports also serve the purpose of keeping the Regional Administrators informed with respect to the cases in their offices. Mr. Green said that he reports to the Home Office on the work he does for other Regional Administrators and asked whether he is required to make such a report. Mr. Holden replied in the negative but pointed out that work done for other Regional Administrators could properly be shown in his Semi-Annual Management Report.

Mr. Newton advised that he has many cases on his docket which are not getting attention because in the last year he has had several big criminal cases. The attorneys dislike writing progress reports and saying "No Progress". Mr. Holden advised that in cases

where no progress has been made the Progress Report should state why no progress has been made.

The last item with respect to Reports of Investigations to be discussed was Closing Reports. Commissioner Patterson advised that the formula suggested in the Chairman's memorandum of March 15, 1954, seems to be working out satisfactorily. However, occasionally a regional office will submit only a short statement to the effect that, in view of the disposition of either criminal or civil proceedings, the case should be closed. A closing report should be submitted in every case.

Mr. Holden stated that the majority of closing reports are satisfactorily prepared. However, in a few situations where a case is being closed after 4 or 5 years of investigation and/or litigation a short closing report is submitted. In such cases the Division of Trading and Exchanges has felt it necessary to review the files and prepare a longer and more detailed report to the Commission. He believes the longer type of report can be prepared in less time in the regional office by the attorney who has handled the case and knows the facts than by an attorney in the Home Office who would have to review the files. He pointed out that the longer type of report need not cover more than two or three pages but it should contain all essential information so that the Commission when considering whether to close the case will have all the data it needs.

Mr. Brown thought that long and detailed closing reports are needed in cases where violations were found but no action was taken.

Mr. Moran said that after discussing such cases with Chairman Demler he started sending long form reports. Mr. Holden advised that the Chairman's memo of March 15, 1954 refers to that type of case but leaves the choice of a long or short report to the Regional Administrator. He added that the report, whether long or short, should recite the facts and state why no action was taken.

This concluded the discussion with respect to "Reports of Investigations".

Reference to State Authorities

Commissioner Patterson announced that the second topic for discussion was Reference to State Authorities. He recalled that in September, 1953 the Chairman directed a memorandum to Regional Administrators authorizing them to refer cases directly to state authorities under the conditions set forth in the memorandum. The purpose of that procedure was to relieve Commission staff from further work in cases which could be adequately handled by state authorities. It was not intended that the Commission would develop violations of state law for the states. He said that while no routine has been established for following cases after they have been referred, it would be helpful if Regional Administrators would follow these cases and report to the Home Office what disposition is made by the states. He mentioned that the Chairman's memorandum also directed that a receipt be obtained for any documents turned over to state authorities which receipt would become a part of the file in the Home Office. He called attention to this because it appears that some matters have been referred to state

authorities without prompt notification to the Home Office and without forwarding the necessary receipt.

Mr. Holden added that the Commission often asks him what the state did in particular cases and he urged the Regional Administrators to establish some procedure whereby they can follow a case referred to the state.

Mr. Moran thought the suggestion was a good one for the additional reason that if we know the actions taken by the states, we can mention them in our annual report and thereby inform Congress of that phase of our activities. Mr. Glavin agreed with Mr. Moran and suggested that we select several cases which were referred to state authorities and which have appeal and write them up in our annual report.

Mr. Holden advised the administrators that when he presents an enforcement matter to the Commission he is asked whether the case is one which should be referred to a state authority and he must have the answer. He asked them to state in their reports why a case was not or should not be referred to a state authority.

Due to peculiar situations in their region several administrators did not think satisfactory results could be obtained by referring cases to state authorities.

Mr. Newton advised that the states in his area do not have any security fraud statutes or effective securities commissions. Consequently, when he refers a case it is given to a local prosecuting attorney who does not know securities law and cannot effectively prosecute. He

cited the fact that the State of Washington has had only one case of fraud in securities in 19 years. He said that so far as the other states in his region are concerned, if any action is taken it is on a watered down case and results in a watered down penalty.

Mr. Green stated that he has the same situation in his region. There are no fraud statutes with respect to securities and any prosecution would be for technical violations such as the failure to register. It is his opinion that reference to states does not work out satisfactorily. Hence, what he does is to advise a state authority that he is going to make an investigation in a certain matter and asks for cooperation by the state which is usually given in the form of an attorney or accountant to do the leg work.

Mr. Hart said that it is a waste of time to refer criminal cases to state authorities in his region. He cited an embezzlement case which he referred. He gave copies of the report to the state attorney and offered the assistance of accountants and attorneys. Action was promised. However, when after five conferences Mr. Hart realized that no action would be taken, he went into the federal court and obtained an injunction against filing false financial reports, which was the best he could do at the time.

Mr. Allred said that there is practically no enforcement by state authorities in his region and that the program of referring cases to them would not work out satisfactorily.

Mr. Clavin reported excellent results in his area because the Martin Act in New York is better from an enforcement standpoint than

either the Securities Act or the Securities Exchange Act and The New York Attorney General has a very eager and competent staff.

Mr. Hart then spoke of cases in his region involving two employees of a New York Stock Exchange firm. He and the state started investigations at the same time. Restitution was made and the state dropped the cases. He wondered whether in view of the failure of the state to proceed he should continue his investigation. He said that the employees were no longer with the stock exchange firm but they may go to work for some other registered broker-dealer and for that reason it may be advisable to develop the case for the purpose of making the record against them.

Mr. Reid recalled a case where the New York Office had investigated embezzlements and turned over to The New York Attorney General the information we had. Convictions were obtained but no credit was given to the Commission. Mr. Holden remarked that he did not think it was intended that we should refer to the state cases which we had fully developed. The plan is to turn over cases which have not been fully investigated but which indicate violations of state laws, so that the regional offices would be relieved of some work.

Mr. Glavin said that the NASD in New York City has knowledge of situations as soon as we do if not sooner. He recalled that recently it had information which it gave to us one day and to the New York Attorney General the next day. He moved in swiftly and obtained an injunction.

PROBLEMS PRESENTED BY THE

R. V. KLEIN DECISION

This was the third topic for discussion. Those present were furnished with copies of the opinion of the U. S. Court of Appeals for the Second Circuit issued June 16, 1955 in the matter of Rudolph V. Klein, doing business as, R. V. Klein Company. In January 1952 the Business Conduct Committee of the NASD District in which Klein conducted his business charged him with violation of the Association's rules of fair practice in the sale of oil royalties to two customers. This Committee found that Klein's mark-up on the securities sold was 50%; that this mark-up violated NASD's rules of fair practice and censured Klein and assessed him the cost of the proceeding. The Board of Governors on its own motion took the matter under review and increased the penalty from censure to expulsion. Klein appealed to the Commission which affirmed the decision to expel Klein from the NASD. Klein then appealed to the U. S. Court of Appeals for the Second Circuit.

Mr. Blair opened the discussion by stating that "the R. V. Klein decision, by holding that a failure by the NASD to take action upon 1950 transactions effected by R. V. Klein Company constitutes an implied interpretation of the NASD Rules which precludes the Commission and the NASD from concluding that later transactions of similar nature fell within the prohibition of those Rules, appears to enunciate a novel doctrine of quasi-estoppel. The distinction between this new doctrine of quasi-estoppel and the established principle of estoppel which the

Court found not to be applicable to an administrative body is not apparent. Because respondents in administrative proceedings and defendants in civil and criminal proceedings will naturally try to find comfort in the Klein decision, it appears desirable to offset the effect of this decision by reviewing presently established investigative or inspection procedures for the purpose of eliminating any that might lend themselves to a later claim that the Commission had made an 'implied interpretation' which had the effect of granting immunity to otherwise actionable conduct.

"While there is probably no way of completely overcoming the effect of the Klein decision, and our reliance will undoubtedly be placed for the most part on facts to distinguish future cases, the need to advise offenders of the nature of their offenses at the earliest possible moment consistent with the interests of the Commission, a practice generally followed, is worth noting again at this time.

"The effects of the Klein decision will also be felt in connection with administrative and judicial proceedings whenever the defense of an 'implied interpretation' is raised. The problem will then be the extent to which testimony bearing upon prior conduct should be allowed to be adduced without objection by counsel for the Commission or the Division of Trading and Exchanges. Here again, no hard and fast rule can be laid down, and it would appear that good judgment must be relied upon to set the limits and prevent a case from getting out of hand."

Mr. Moran asked whether his understanding is correct that where a Regional office makes an inspection or investigation and discovers violations but decides not to take action it must write to the persons involved stating that there were violations but that for stated reasons no action would be recommended to the Commission. In other words, make sure that the Commission is not estopped from later instituting proceedings for similar violations. Mr. Blair said that is correct but added that the Regional Offices should be sure to protect the equity of the Commission by not seeming in their notification to condone unlawful conduct. He advised that the staff does not think the doctrine of quasi-estoppel in the Klein case is sound.

Mr. Pennekamp remarked that he thought the Klein case was being given too much importance in view of the fact that it concerns actions by the NASD rather than the Commission. Mr. Blair replied that the staff feels the decision is applicable to matters of original concern to the Commission as well as to NASD actions that are reviewed by the Commission. He added that the staff deems it preferable to notify possible respondents before hand rather than to argue the matter in court if the former can be done consistently with the interests of the Commission in the investigation or inspection.

Mr. Brown had some doubt about the practicalities of the suggested procedure. If major and minor violations were found and the registrant was advised of the minor ones only, he may be led to believe that there were no other ones. If he were advised of the major ones also,

he would have to be told that they would have to be considered by the Commission and we would thereby tip our hands. It was the consensus that no notification should be given until after it had been determined not to take any action with respect to any of the violations found.

Mr. Blair emphasized that our aim should be to prevent a respondent from taking any comfort from the Klein decision.

SPECIAL INVESTIGATIONS UNIT

This topic was introduced by Commissioner Paterson who said Office Memorandum #157 states that the Division of Trading and Exchanges shall have on its staff personnel available for temporary assignment to regional offices to aid in the conduct of specific investigations and to conduct such investigations as the Division may be authorized by the Commission to handle directly.

For a considerable period of time Messrs. Callahan and Jaegerman have been engaged principally in handling investigations which are supervised directly by the Division of Trading and Exchanges and in assisting regional offices in certain other investigations. It is anticipated that they will be continued in that type of work and it is planned that the services of these men will be made available to assist Regional Administrators upon request, or by direction of the Commission, in bringing to a conclusion investigations in which such assistance may be desirable. When they are made available to a Regional

Administrator, they will work under his direction on the particular matter to which they are assigned. It is the feeling in the Home Office that the long investigative experience of these men may be valuable in particular investigations and in assisting regional office personnel. They, of course, will also be used in investigations which are handled directly from Washington.

Mr. Newton said that he assumes that the cases on which they would work would be ones which would result in criminal prosecution. If that is the case, he thinks that so far as his region is concerned, it will be necessary for them to work with a regional office attorney because in the States of Washington and Oregon, after a matter has been referred to the Department of Justice for a criminal prosecution, a regional office attorney ordinarily prepares the indictment, and assists in presenting the matter to the Grand Jury and in the conduct of the trial. Since regioal office attorneys are called upon to aid in this manner, he feels that they should be familiar with the case; otherwise Messrs. Jaegerman and Callahan would have to return to do this type of work.

Mr. Blake stated that he thinks there should be adequate publicity as to why Messrs. Jaegerman and Callahan are being sent into a particular region. He informed the conference that the public reaction with respect to the Task Force which is operating in his region is that the Denver Regional Office fell down on its job and that Washington had to take over. The same public opinion would exist if the Special

Investigations Unit were sent into a region. Mr. Loomis replied that the public had been informed as to why the Task Force was sent into the Denver Region and that because of the nature of the work of Messrs. Jaegerman and Callahan he did not think it would be possible to announce that they were to be in a certain region for a certain purpose.

Commissioner Patterson indicated that later on, possibly in 1957, we would be able to increase this Special Investigations Unit. Mr. Marshall said that he thinks that if any new personnel are to be hired, we should consider assigning them to the regional offices rather than to a Special Unit. He feels that the regional administrators can use additional personnel better if they are actually assigned to the regional office staff.

Commissioner Patterson stated that the last topic was to have been the new stabilization rules but that since time was short, he wondered whether the regional administrators would be willing to omit discussion of these rules. Mr. Green stated that he would appreciate a full discussion of the rules since he had a few questions with respect to them and, more important, he would like to hear the questions and views of the other regional administrators. Commissioner Patterson stated that he would try to arrange a time for discussion of the stabilization rules.

CONFERENCE ON SEPTEMBER 28, 1955

COMMISSIONER ORRICK PRESIDING

When the conference regarding broker-dealer matters opened Commissioner Orrick enumerated the various topics which would be discussed. He introduced the first topic- The Cooperative Inspection Program- by stating that about a year and a half ago the Commission instituted a policy of cooperation with other agencies with a view to establishing a more effective inspection program. The purpose was to set up in the Commission information concerning the timing of inspections by the Exchanges, the NASD, and the state authorities to eliminate overlapping of inspections by various agencies and to accomplish more effective spacing of inspections by the agencies. The Exchanges which have inspection programs and the NASD have been fully cooperative in furnishing this information to the Commission, which is promptly transmitted to the appropriate regional offices. Commissioner Orrick said that the program appears to have operated successfully and the Regional Administrators were asked for an expression of their opinion.

Mr. Newton said that so far as he is concerned, a weak spot in the program is the failure of the NASD to advise him of the members to be inspected and when they will be inspected. He said that it was embarassing to go in to inspect a broker-dealer and find that the NASD had been there a short time before. Mr. Keenan replied that the program

does not contemplate that the NASD will give us advance information as to exact names and dates. He added that the solution to Mr. Newton's problem is to arrange to have the NASD representative in Seattle advise the members he intends to inspect in a succeeding period of time and for Mr. Newton not to schedule routine inspections of any of those members until and unless he ascertains from NASD reports of actual inspections that the proposed NASD inspection did not take place. Mr. Newton said that he had tried to make such arrangements but was told by the NASD representative that he was not authorized to do so.

Mr. Ferrall reported that the NASD representative in New York asks our New York Regional Office when we last inspected certain members and that means that the NASD intends to inspect them within 30 days.

Other Regional Administrators reported that they had made similar arrangements.

Mr. Loomis said that we would contact the Main Office of the NASD with regard to making appropriate arrangements with our Seattle Regional Administrator.

Mr. Hart reported that his arrangements are effective in the Chicago area of the NASD but not entirely effective in two other NASD areas located in his region. For example, his inspectors met NASD inspectors in Cincinnati.

At this point inquiries were made as to whether the NASD furnished the Commission with copies of their reports of inspections, the scope of their inspections, and whether they could be relied upon.

Mr. Keenan advised that the NASD does not furnish copies of their inspection reports to the Commission and that, of course, the Commission does not furnish copies of its reports of inspection to the NASD. It indicates to the Commission cases of embezzlement but does not even indicate other unlawful activity. He explained that the NASD inspectors look primarily at pricing practices and activity in accounts and then at books, records, and hypothecation with very little attention to financial condition. In some instances they may take off a trial balance.

Mr. Marshall said that his men inspected a broker-dealer two weeks after an NASD inspection and found violations of our net capital rule. He thought that since we have this cooperative program we should not hesitate to ask the NASD what it is doing. Commissioner Orrick replied that we cannot force the NASD to make any particular type of inspection. The program seeks (1) to obtain as much coverage as possible, the theory being that any coverage is better than none, and (2) to eliminate successive inspections of a broker-dealer by various authorities within a short period of time.

This led to the question whether we were precluded from making an inspection within six months of an NASD inspection and the answer was "No". We may make an inspection within that time if we have reason to believe that we should.

Regarding inspections by State Commissions, it was reported that only eight or ten make any inspections and these states did not report many. For example, Wisconsin has not reported any inspections during the past year.

Mr. Keenan advised that the Division is considering setting up a master record on all broker-dealers so it can readily ascertain when a particular one was last inspected by any agency and which ones have not been inspected at all. The Division is interested in knowing if information of this nature is readily available to, or would serve a useful purpose in the regional offices. If these records are set up the regional offices would be requested to furnish to the Division information supplied by the states comparable to that now furnished by the NASD and the Exchanges. The Division sees a use for this master record in connection with budgetary problems and inquiries from the Congress. It was the consensus that this information is available in the various Regional Offices and that the master control record would be valuable only to the home office.

INSPECTION MANUAL AND REPORT FORMS

The next matter for discussion was The Inspection Manual and Report Forms which were adopted about a year ago. They appear to be satisfactory. The time required to prepare the inspection report has been shortened by the use of the simplified report form. 822 inspections were made in fiscal 1955 as compared with 788 in fiscal 1954, an increase of 34. The Commission hopes that the inspection program can be stepped up and has asked for money with which to hire additional inspectors in fiscal 1957.

Mr. Hart said that according to his understanding of the instructions in the manual he must make a solvency examination if the broker-dealer has not filed a certified report within six months of the inspection date. These instructions require him to make solvency examinations where he feels they are not required. He suggested that Regional Administrators be given some discretion in the matter and said that if such discretion were given he could make 20 or 30 more inspections per year.

It was the consensus that although the instructions required regional administrators under the circumstances mentioned by Mr. Hart to make some type of financial examination they had discretion as to how much of an examination to make.

Mr. Newton referred to Paragraph 9(b) of the Manual relative to making appropriate inquiry as to the delivery of prospectuses and asked what is considered as an appropriate inquiry. He cited cases where there are no records, such as signed receipts, showing delivery of prospectuses and asked whether it is sufficient to ask the broker-dealer and rely on his reply or whether customers must be interviewed. Mr. Holden replied that the Regional Administrators must exercise judgment as to how far to go based on his knowledge of the broker-dealer.

Mr. Krys referred to the question on the check sheet with respect to segregation of customers' securities in accordance with the

Chandler Act and stated that in his opinion this question was meaningless since it was not known what segregation was considered proper under that Act. He also stated that brokers-dealers in the Denver Region do not segregate customers securities and when the question is raised they ask what law requires them to do so. Mr. Ferrall said that while there were no court decisions in the matter it is his opinion that segregation meant putting the securities of each customer in a marked envelope or attaching to each certificate a sticker with the owner's name on it. He suggested a program to educate brokers and dealers as to the advisability of segregating customers' securities and how to do it.

Mr. Loomis said consideration would be given to revising the check sheet so as to require a "yes" or "no" statement as to whether customers' securities are segregated without reference to the Chandler Act.

Mr. Ferrall then referred to the preamble to the Inspection Manual and suggested that it be revised to read "were there problems" rather than "were there violations"

COOPERATION OF REGIONAL ADMINISTRATORS IN PROCESSING BROKER-DEALER APPLICATIONS.

The next topic for discussion was the cooperation of the Regional Administrators in the processing of applications for registration as brokers and dealers. Mrs. Murphy pointed out that when an application is filed a copy is sent to the appropriate Regional Office. The Regional Administrators have always furnished any information relating to an applicant which is not available in the Home Office and have, upon request, obtained additional information. This assistance and fine cooperation of the Regional Administrators are very much appreciated. Mrs. Murphy said that since the adoption of Rule X-15B-8 it has also been the practice to ask the Regional Administrators for help in cases where an applicant is located in or near a regional office city and it appears from the report of financial condition filed with his application that he is insolvent or would not be able to comply with the net capital rule if he were to become sub ect to it. The Division believes that such a case can be handled more quickly and

and efficiently in person than by correspondence since the parties will have an immediate opportunity to explore the situation and discuss possible solutions. The Division has also felt that the Regional Administrators are interested in having these cases brought to their attention. However, since the cases will become more urgent and numerous if and when Rule X-15C3-1 is amended, as proposed, to eliminate certain exemptions, it was deemed advisable to ask for an expression of opinion. The Regional Administrators expressed themselves as follows:

Kendrick - Wants to handle all cases in the Boston Region.

Glavin - Wants to handle only those cases in the New York City Metropolitan Area. We should handle the other ones in the New York Region.
He explained that he could not send anyone outside the Metropolitan Area and would have to write a letter.

Marshall - Wants to handle all in his region.

Green - Wants us to handle all cases in his region. He does not even want to handle the Atlanta cases.

Allred - Wants us to handle all cases in the Fort Worth area.

Blake - Wants to handle cases in Denver and Salt Lake City only. We should handle the ones in other parts of his region.

Blackstone- Wants to handle cases in San Francisco and Los Angeles only.

Newton - Wants to handle all cases in the Seattle Region.

Hart - Wants to handle all cases in the Chicago Region.

RULE X-17A-5 REPORTS

The conference then opened a discussion regarding financial statements pursuant to Rule X-17A-5. Commissioner Orrick said that he had been informed by the Division that the Regional Administrators had done an excellent job in obtaining financial statements. The number of delinquents for 1954 were considerably less than in prior years. The Regional Administrators have given prompt attention to obtaining financial statements from some delinquents which reports, though not acceptable as a filing under Rule X-17A-5 nevertheless informed us of the financial condition of the registrants. In other instances, withdrawals were obtained or revocation proceedings were recommended and instituted. He said there were only seven delinquents where no action had been taken and that we know that four of them will be soon eliminated.

Mr. Pennekamp suggested that Rule X-17A-5 be amended to eliminate the year-end filing rush. He thought the rule should be amended to require the filing to be made within a year of the date of registration and each anniversary.

Mr. Krys suggested that Form X-17A-5 be revised to conform to Rule X-15C3-1 as amended effective May 20, 1955. Mr. Newton specifically suggested that the revision require a more complete description of securities so as to permit us to calculate the so-called

"haircut" which differs according to type of securities.

Mr. Loomis advised that amendments to Rule X-17A-5 were being considered and that the foregoing suggestions would also be considered.

NET CAPITAL PROBLEMS

Commissioner Orrick advised the Regional Administrators that if and when Rule X-15C3-1 is amended as proposed they should request each registrant who, was not previously subject to the rule and whose X-17A-5 report showed inability to comply with it, to submit another financial report. He also said that if analysis of a financial report indicates non-compliance with Rule X-15C3-1 the broker-dealer should be put on notice of the capital deficiency and directed to advise the Regional Administrator of the steps it has taken or will take to correct the situation. The check sheet should show these actions.

The lack of uniformity in handling violations of the net capital rule was discussed. It was brought out that some administrators keep a firm which does not comply with the net capital rule under surveillance by frequent inspections while another administrator requires monthly reports and a third administrator requires that additional capital be obtained immediately. It was suggested that when a broker-dealer is found to be in violation of the net capital rule the Regional Administrators should give him a short period of time in which to obtain sufficient additional capital and seek an injunction promptly

if he fails to do so. When the broker-dealer is an exchange member, the exchange should be promptly notified and put on notice of its duty to police its own members.

MISCELLANEOUS

It was also pointed out that throughout the years our inspections have been impeded by registrants' failure to make and keep current books and records and that in most cases the Administrators have not recommended any action against the violators. However, a short time before the conference the Washington Regional Administrator obtained an injunction in the District Court for the District of Columbia based solely on failure to make and keep current books and records.

Mr. Hart said that he is irritated by minor violations which do not justify the expense of revocation proceedings or injunctive action. He suggested legislation which would give the Commission power to take some other action such as a summary suspension.

Commissioner Orrick closed the session with a short statement of the inspection goals for fiscal 1956. He said that with the three additional inspectors to be hired and the task force working in the Denver Region he thought we should reach 900 inspections.

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