CHAPTER II

QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

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CHAPTER II

QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

A. INTRODUCTION

1. THE THEORIES OF REGULATION OF QUALIFICATION STANDARDS

In recent years the world of securities has attracted many newcomers, some as investors who have enthusiastically discovered corporate securities as a medium of investment or speculation, and others as members of the securities industry who have been drawn by the magnets of prestige and potential earnings.[1] The lack of sophistication of so many in the first group has combined with the lack of qualifications of so many in the second to create problems for the various agencies, governmental and private, that are charged with protecting investors and the public interest with which the securities industry is affected. Few persons associated with the securities business for a number of years would disagree with the comments of Amyas Ames, president of the Investment Bankers Association (IBA) at its November 1962 annual convention, on the influx of new blood into the business which has taken place over the past decade and a half:

> We have built a fine record in recent years, but mistakes have been made. To name a few: We have grown too fast; we have taken on too many men without training them thoroughly enough; we haven't trained enough managers; some people have come into the business who aren't qualified. * * *

The regulatory problems engendered by the rapid influx of newcomers present a challenge which cannot be met by merely adding to the police force, an approach which is neither desirable nor feasible. It is the belief of the study that the gateway to the industry is the point where government and industry should look first for the solution of some of these problems, and that adequate controls over entry into the industry are an alternative to be preferred over an abundance of regulations and too many policemen. This chapter examines the adequacy of the existing structure of controls, and suggests some means for its improvement.

The subject of controls over entry into the securities business—the rules and practices designed to assure that individuals and firms will be properly qualified in character and integrity, knowledge and experience, and financial responsibility—is typical of many covered in this report in at least one important respect: the great contrast that may be found between the best that has been accomplished and the deep deficiencies that still exist. For some segments of the business the controls are strong, for others they are of varying intermediate degrees

[1] The growth of the securities industry is described in ch. I.B, above.

of effectiveness, and for still others they are virtually absent. From the point of view of the public to be protected, a fence can be no more effective than its lowest section, and it is the low sections that present a continuing danger and challenge to the regulatory agencies. Regardless of the gratifying advances that have been and are being made in some areas, the nagging question remains of how it is still possible for thousands of unqualified persons—many of them heading firms—to engage in the securities business with the public.

Some part of the answer to the question lies in the philosophy which underlies the Federal securities laws. The basic approach regarding entry which was taken by the draftsmen of the Securities Exchange Act of 1934 (requiring Federal registration of broker-dealers), the Maloney Act of 1938 (establishing the National Association of Securities Dealers, membership in which is an economic necessity for the great majority of broker-dealers), and the Investment Advisers Act of 1940 (requiring Federal registration of advisers), was to permit free access and unlimited entry into the securities business by anyone against whom the Commission had not previously acted and who had not violated certain securities laws. To be free to engage in the securities business a broker-dealer need only observe the formality of registration with the Commission. Such other restraints and sanctions as are contained in the Commission's arsenal—its rules proscribing fraudulent activities and requiring maintenance of books and records and an appropriate ratio of capital to liabilities—have force and effect only after the newcomer is engaged in business and, often, after the investing public has suffered a certain amount of injury.

Essentially the same philosophy of relatively unlimited access to the business has historically determined the admissions procedures of the NASD. The statutory grant of authority to establish economic distinctions between members and nonmembers, on which its existence is posited, has been interpreted by the Commission to be conditioned upon the association's leaving its door open to most broker-dealers who register with the Commission.[2] Since the NASD was founded, the open door has been closed an inch: inexperienced principals and salesmen of new firms are required to pass an examination testing their elementary knowledge of securities and securities markets. But the association may not adopt the exclusionary policies or the philosophy of limited access represented by the exchanges, and it has moved cautiously in exercising what selective powers it may have.

The Federal Government and the federally sponsored NASD have the broadest responsibility for determining who may engage in the securities industry. They do not cover quite the entire field. Nevertheless for significant portions of it, where the exchanges lack authority and the States have failed sufficiently to exercise theirs, the only protection afforded is that of the Commission and the NASD. At the same time, the protection that these bodies afford is generally the shallowest, and therefore it is their controls that need greatest strengthening. Instances of stronger controls exercised by other agencies may serve as general points of reference, and the most effective controls may serve as ultimate goals.

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[2] *In the Matter of the National Association of Securities Dealers, Inc.*, 12 S.E.C. 322 (1942). This decision is discussed in pt. B.3, below.

2. SCOPE OF THE CHAPTER

The problem of qualifications for entry into the securities business involves several dimensions. One is the different types of standards of character (honesty, integrity, and responsibility), of competence (knowledge and skill), and of financial capacity and commitment which the public interest requires to be imposed on those engaged in it. A second dimension relates to the differing functions performed within the business by its various components and personnel—the broker-dealers engaged in retailing, wholesaling or underwriting securities, the salesmen engaged in selling different types of securities, the supervisors, and the persons providing investment advice. A third dimension relates to the source of regulatory control—the authority and responsibility residing in the Federal Government, the several States, the various exchanges, the NASD, and the individual securities firms.

In terms of these three dimensions, the chapter will show what parts of the total field are protected, by whom and how well, and what parts remain partly or wholly unprotected. The basic organization of the chapter is in terms of separate functional categories; broker-dealers are considered first, then salesmen, supervisors, and investment advisers. Within each of these categories, the controls exercised by the various regulatory bodies are considered in turn and the major unresolved problems are analyzed. There is also taken up, within this framework, the different elements of qualifications, such as character, training, and financial responsibility, and also the variances with respect to different types of securities, particularly the differences between mutual funds and corporate securities generally. Certain aspects of the training of mutual fund salesmen, however, are so closely related to those features of selling practices and supervision which are uniquely characteristic of mutual fund selling that they are considered, with other mutual fund matters, in chapter XI.

3. METHOD OF STUDY

The Special Study's investigations of the problems of qualifications of persons engaged in the securities business and the related areas of industry selling practices in general[3] and the selling practices of mutual fund distributors[4] were conducted together. Primary emphasis was placed on interviews, private hearings, and correspondence with various securities firms, industry representatives and staff members of the NASD and the NYSE, and also on two questionnaires, which were sent, primarily on a sample basis, to 247 broker-dealers of varying sizes and types. In addition, representatives from 13 firms, 2 States, the NASD, and the New York and Midwest Stock Exchanges were questioned in public hearings held by the study. Information gathered in other investigations not directly related to the subject of qualifications has also been drawn on in the preparation of this chapter. Some firms also provided the study with their training manuals, personnel selection guides, and other materials.

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[3] This subject is discussed in ch. III.B, below.
[4] This subject is primarily considered in ch. XI, which is devoted to mutual funds.

The two questionnaires, denominated "STS-1" and "STS-2" (for screening, training, and supervision),[5] requested the following information of each respondent firm: (*a*) The organization and business of the firm, including a breakdown of its gross income by sources; (*b*) the basis and amounts of compensation of salesmen and supervisors; (*c*) the numbers of salesmen and supervisors employed by the firm on April 1, 1962, and the numbers of those newly entering and those leaving during the year, the methods by which these persons were screened, and the types of training given them; (*d*) the content of the firm's training program for new salesmen, including the number of hours and weeks devoted to each area of study; (*e*) the times at which newly hired salesmen take various examinations and start selling securities to the public; (*f*) the supervisory practices by which the firm checks on the activities of salesmen; and (*g*) the policies and procedures intended to prevent the occurrence of certain undesirable practices.

Tables summarizing the information derived from the questionnaires are set out at the close of this chapter, and identified by Arabic numerals (e.g., table II-1). Some tables integrally related to the discussion appear in the text, and are identified by lowercase letters (e.g., table II-a). Certain of the data are discussed in other chapters of the report. For the most part when material drawn from the STS questionnaires or tables is discussed in the text in terms of percentages, the percentages have been computed on a weighted basis so as to speak of the entire group of firms from which the sample was taken. Firms referred to in the text (in discussions of data from the STS survey) as "mutual fund firms," "firms primarily engaged in the sale of mutual funds," or the like, are those which earn from the sale of mutual fund securities 50 percent or more of their total gross income from securities transactions. A discussion of the method of weighting, and of the sampling technique used, the ratio of responses to requests, reasons for failure to supply requested information, the adequacy of the survey as it pertains to particular subjects touched upon in the questionnaires, and the basis of extrapolation upon which the data are expressed in the tables, is contained in appendix A.

B. Qualifications of Broker-Dealers

1. CURRENT PROBLEMS OF CHARACTER AND COMPETENCE

The effectiveness of the controls governing entry into the securities business by broker-dealer firms and their principals must be measured in large part by the character and ability of the persons who have come into the business, and thus have been found acceptable under the screening processes of the regulatory bodies concerned. It would be idle to suppose that such bodies could eliminate all wrongdoing in the securities business, or detect in advance all incompetents and potential malefactors. Nevertheless, effective screening can help eliminate some whose histories foreshadow future difficulties, and reasonable training requirements can limit the number of those for whom reckless or improper conduct stems from inadequate knowledge and scanty preparation.

[5] Copies of the questionnaires appear in apps. B and C to this chapter.

From the evidence gathered by the study, it appears that the existing controls have proven to be deficient in some important regards. The dishonest broker-dealer, that "greatest menace to the public," to use the words of one Commission official, continues to appear with unjustifiable frequency. Also, the inexperienced broker-dealer too often blunders into problems for himself, his customers, and the regulatory agencies. The discussion which follows shows instances in which better qualification standards imposed at the point of entry would have made the occurrence of subsequent difficulties less likely, and it analyzes the significance of the role played by broker-dealers who have relatively little experience.

The persons with whose qualifications this part is concerned differ considerably from one another, in terms both of the aspects of the securities business in which they are involved and of their responsibilities and duties within their firms. A principal of a broker-dealer firm may be one of dozens of partners or vice presidents in a large underwriting and general securities firm, or he may be the sole proprietor of a firm whose only activity is selling mutual fund shares. Each of these persons, together with all other principals and proprietors in the industry, shares the common attribute of ownership, or part ownership, of a broker-dealer firm with which he is actively associated, and thus shares responsibility for the policies followed by that firm. It is the responsibilities and duties that these persons have in common which delimit the qualification standards applicable to them, regardless of the other areas in which they may be active. All broker-dealer principals should have a certain degree of experience and knowledge related to the operation of a securities firm and the supervision of sales and other personnel, including knowledge of applicable parts of the securities laws and rules. In addition, there are of course certain standards of integrity below which none should fall.

The community of broker-dealers, as has been suggested in chapter I.B, is composed on the one hand of a fairly small group of giant organizations, including firms doing a general securities business as well as large mutual fund sales organizations, and, on the other hand, of a much larger group of smaller firms, with a smaller but still significant share of the public's security business. This latter group contains numerous and important firms with a general business in listed and over-the-counter securities as well as other types, and a substantial number of firms specializing in the sale of mutual funds. As has been seen,[6] it is in this group of smaller firms that the high turnover of the broker-dealer community is concentrated. Almost all new broker-dealer firms start in this category of smaller firms, including some with principals whose knowledge of the business is so inadequate or whose integrity is so lacking as to endanger the public investors with whom they do business. It is on the group of smaller firms, therefore, that a study of the problems of control over qualifications of those who would become broker-dealers must mainly focus.

There follows a series of four case histories of new broker-dealer firms. These case histories are not included as being by any means typical of all new broker-dealer firms, although they are all too rep-

[6] See ch. I.B, above, on size and turnover of broker-dealer firms.

resentative of a large number of firms, and it is this fact that gives cause for concern about how well investors are protected. Principally, however, the case histories illustrate some important deficiencies on the part of their principals in meeting even standards of competence and ethics which should be minimal, the problems for the public and the regulatory agencies engendered by such deficiencies, and the inadequacy of present controls over entry to prevent such problems from arising.

a. Case studies

(1) *William, David & Motti, Inc.*

One of the securities firms which went bankrupt as a result of the sharp decline in the market of May 1962 was a New York City broker-dealer named, William, David & Motti, Inc. Founded less than 4 years before, this firm had gone rapidly through a complete cycle from initial success and temporary prosperity, through expansion, and on to a collapse which appears to have returned its partners to a somewhat worse position than that in which they started.

William, David & Motti was founded under the name of William, David & Co., in the fall of 1958 by David Zaretsky, then age 29, and William Badia, age 25. The firm did no business for over a year, but did set up an office of sorts in Zaretsky's law office in New York City. Zaretsky's principal experience in the securities business was as an investor, and in preparing a few registration statements. Badia had been a geologist, and he had had no experience in the securities business except as a trader of securities in his own portfolio.

During the firm's first year, it had capital of around $300, contributed by Zaretsky for both partners. Zaretsky and Badia spent the first year in looking for an underwriting and, in anticipation of the underwriting they hoped to secure, encouraging several of their friends to take the NASD examination and register with their firm. These persons were lawyers, accountants, graduate students, and others whom the partners knew at the time, all of them inexperienced in the securities business. They were given no particular training, but passed the NASD exam with high grades after a minimum of preparation.

During the late autumn of 1959 the partners, with the aid of Stelio Motti, then employed as a trader and retail salesman at Willis E. Burnside & Co., Inc., an over-the-counter firm in New York City, discovered an underwriting suitable for their operation. After some negotiating, the William, David firm agreed to take on Motti as an employee, not as a partner, although his name was added to the others' first names to form the firm's name. As Zaretsky later testified:

> Well, basically we needed someone who was experienced and [Motti] was the experienced person that we needed. If it wasn't him, it would have had to be someone else.

The three of them also prepared to underwrite, on a best-effort basis, a new issue of 147,000 shares of stock in a company known as Consultants Bureau Enterprises, Inc. At this time the capital structure of the William, David & Motti firm had increased to around $17,000, of which $10,000 was contributed by Badia (borrowed from his father), and about $6,000 by Zaretsky.

During negotiations for the underwriting at the Burnside firm's quarters, Zaretsky and Badia came in contact with a number of secur-

ities salesmen with customer followings who expressed an interest in working for the new firm. As Zaretsky later explained:

> Well, other friends who had been waiting on the sidelines took the test and joined the firm.
>
> * * * * * * *
>
> Some people who had been working for other firms left their firms to join our firm, and some of the Burnside crew of part-timers came over to our firm.

In all, through old recruits and new acquaintances, the firm was able to have between 10 and 20 salesmen on hand to distribute to the public about 100,000 shares of the underwriting, the remainder being sold by members of a broker-dealer selling group formed by William, David & Motti. The salesmen were paid on a straight commission basis, and Motti received an extra commission on the business generated by the salesmen he brought in. Zaretsky and Badia were responsible for the supervision of the salesmen, there being no sales manager at this time.

In spite of the inexperience of its two partners, the firm was immediately successful with the underwriting. Consultants Bureau, first offered to the public in March 1960 at $3 a share, was initially quoted in the over-the-counter market at a high bid of 4¼ a share, after which the stock's price rose gradually and continually to the point where it was quoted at 24½ about a year later. Since reaching this peak, Consultants Bureau has moved steadily down; as of March 15, 1963, its high bid was 1⅜. This underwriting laid the foundation of the firm's short-lived fortune; it grossed over $100,000 in its first venture in the securities business.

After the underwriting distribution to some 750 customers was completed, the firm "began trading stocks." Although the sales force which had aided in the underwriting distribution was reduced to the point where there were only five of six full-time salesmen selling over-the-counter stocks to the public, the firm hired a sizable number of part-time salesmen, most of whom earned little and stayed with the firm only briefly. The firm at this time entered quotations for three to five stocks in the wholesale quotation sheets of the National Quotation Bureau, and the salesmen recommended these and other over-the-counter issues to the public.

During the latter part of 1960 the firm took on a new partner, Morris Chaitowitz, who previously had worked as a part-time salesman for an over-the-counter firm. Chaitowitz decided to go into the securities business on a full-time basis because, among other reasons, he had "made a lot of money in the market." He approached William, David & Motti with an underwriting, which they declined to handle, but he nevertheless decided to work for the firm full time as a salesman. He became a partner after spending 4 or 5 months as a salesman, during all of which time he was in Clifton, N.J., setting up a one-man office from which he "bought and sold securities and mutual funds." In December of 1960, he was allowed by the other two partners to purchase a 10-percent interest in the firm for $50,000, and later he purchased an additional 3-percent interest.[7]

Over the next 2 years the firm engaged in wholesaling and retailing a limited number of over-the-counter issues of securities, and depended on underwritings as the main source of its revenue. Close to

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[7] Further discussion of Chaitowitz's qualifications is contained in pt. B.2, below.

200 salesmen joined and left the firm during the little more than 2 years of its active existence. These persons, many of whom were inexperienced, were given no training other than a brief orientation to the firm.[8] The issues the firm handled were, Zaretsky admitted, speculative but were nevertheless said to be "OK" for a person with an income of $4,000 to $5,000 a year. In the spring of 1962 the market began a gradual decline, new underwritings fell off, and William, David & Motti found itself in financial difficulty. After prices plummeted further in late May, the firm was forced to enter a voluntary petition in bankruptcy.

Almost none of the firm's principals had had any appreciable prior experience in the securities business. One man was selected by the firm to be its sales manager in spite of the fact that he had had previous connections with many disreputable firms, against several of which action had been taken by regulatory authorities.[9]

The only requirements which these "dynamic young fellows," as they were described by their partner, Morris Chaitowitz, had to meet in order to start their own firm were that they pass the NASD examinations for registered representatives and that they have no previous securities violations on their records. These controls were inadequate for the principals of William, David & Motti. They not only lacked the technical knowledge and proficiency necessary to keep the various records required by law, they also appeared to be insufficiently familiar with the legal requirements relating to the proper conduct of a securities business, particularly with public customers. Irresponsibility and disorder characterized much of the firm's operations during its brief career.

The way should be left open for newcomers to enter the securities business, as with any other business, but the public interest demands that newcomers meet minimum standards of competency and show an awareness of their responsibilities before being allowed to approach the public as brokers, dealers, or underwriters.

(2) *ADS and its offshoots*

The limitations of the admissions criteria of the NASD and the Commission were strikingly illustrated, during the latter part of 1961, by the formation of 20 broker-dealer firms by former employees of American Diversified Securities Inc. (ADS), a large organization which at the height of its expansion had employed over 75 salesmen in its Washington, D.C., office and had engaged in the high-pressure distribution to the public of several speculative issues, handling as many as 250 transactions a day. Most of the 20 firms have since gone out of business, many of them as a result of action by the Commission or the NASD.

ADS was founded by Sidney Haddad, in March 1958, as a sole proprietorship under the name of American Diversified Mutual Securities. At the time Haddad was about 28 years old, and his securities experience consisted only of handling his own investments. He previously had been a psychologist at the National Institutes of Health. Frederick Haddad, a brother who later joined the firm, was

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[8] The backgrounds of some of William, David & Motti's 65 sales employees are described in pt. C.1.b, below.

[9] The background of Harold Roof, the individual referred to here, is discussed in further detail in pt. C.1.c, below.

a few years older but had had no greater experience in the securities business. As its original name indicated, the firm's first business was the distribution of mutual funds.

In the autumn of 1958, the firm was incorporated and offered its stock to the public under regulation A, which exempts certain small issues from many of the Commission's formal disclosure requirements. Public investors paid some $175,000 for slightly less than a 30-percent interest in the company, and the balance of the stock was retained by the Haddad brothers.

At the time it undertook the underwriting of its own stock, the new corporation had a deficit net worth of $3,221.72, and had operated, in the 6 months since its founding, at a loss totaling $6,029.51. Shortly after the offering, the firm eliminated the word "Mutual" from its name, although it had stated in its offering circular that it was concentrating on the sale of mutual funds and intended to establish new open-end investment companies of its own. It shifted the emphasis of its efforts to underwriting and distributing a series of new issues of small corporations whose operating histories and financial conditions were highly unpromising. In spite of the pessimistic tenor of the prospectuses and offering circulars describing these securities, they were rapidly purchased by the public and traded in the "after market" at substantial premiums over their offering prices. Of four issues for which ADS acted as principal underwriter, all but one have since become virtually worthless. Monowall Homes, Inc., a regulation A offering, issued at $2 a share on June 20, 1960, was quoted at 7 bid on August 30, 1960, but by January 31, 1963, was down to one-eighth bid. Another issue, Magna Bond, Inc., which came out at $2 a share in January 1960 (as a regulation A offering), later reached a high bid of 21½ on April 3, 1961. On December 19, 1961, the company became the subject of bankruptcy proceedings. A third underwriting, Washington Mortgage & Development Co. (now Universal Mortgage & Development Co.), oversubscribed at $5 a share in November 1959 and quoted at 11¾ bid a year later, was recently quoted at 3 bid.

A considerable portion of ADS's transactions with the public was in stock from its fourth underwriting—of ADS itself. ADS common was quoted at 2 bid in July 1959; in July 1960 it was quoted at 26½ bid, placing a purported evaluation of the virtually insolvent firm at over $6 million. On April 25, 1961, upon motion of the Commission, the firm was declared to be insolvent by the U.S. District Court for the District of Columbia and a receiver of its assets was appointed.

Shortly after its underwriting activities had begun, the firm apparently entered a period of chaotic recordkeeping, culminating in September 1960 with a district court judgment enjoining ADS and Gildar & Co., a closely affiliated firm sharing the same address as ADS, from effecting securities transactions until their books and records were brought into compliance with the Commission's recordkeeping requirements under the Exchange Act.[10] The Commission's affidavit supporting its injunction suit quoted the firm's accountant as estimating that it would take at least 4 to 6 months to put the records "in a current and accurate condition."

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[10] Litigation release No. 1789 (Sept. 26, 1960).

ADS resumed business in January 1961 after a 3-month hiatus, during which time branch offices had been organized in New York and Miami [11] and several of its salesmen left to form firms of their own. Finally, in April 1961 a permanent injunction was secured by the Commission, forbidding the firm from further violating the Commission's net capital rule, and a receiver was appointed when it was shown that the firm's liabilities exceeded its assets by approximately $402,000.

Most of the many salesmen whom ADS employed were recruited through newspaper advertisements or were brought to the firm by friends already employed there. Most were inexperienced when they came to ADS and obtained from the firm whatever training they received, which apparently consisted of a perfunctory orientation to the firm, along with whatever information was made available by fellow salesmen and in periodic sales meetings. Many of the salesmen were young, and some of them worked only part time.

In spite of what may appear to be a lack of experience on their part, a large number of ADS' salesmen left the firm to set up broker-dealer firms of their own: many of them departed after ADS began to encounter its difficulties with the Commission. In the period of September 1958 through November 1961, 30 former sales employees of ADS participated in the founding of 20 new firms, all but 2 of which were located in the District of Columbia. Of these entrepreneurs, some of whom acted as sole proprietors, 24 had received their only securities experience at ADS. Only two of the other six founders had had more than 2 years' experience prior to joining ADS.

Few of these ventures proved to be successful. Of the 20 firms, 8 have since withdrawn their broker-dealer registrations, and only 2 of the remaining firms have failed to be the subjects of Commission or NASD action. The disciplinary actions include one broker-dealer revocation and six expulsions from the NASD.

One of these firms was Best & Garey Co., Inc. (Best & Garey), founded in October 1960 by Thomas M. Garey, who had worked as a part-time mutual fund salesman for ADS' predecessor firm during the summer of 1958, immediately following his graduation from George Washington University. From September 1958 to August 1960, when he left a job at the Bureau of the Census to work for ADS full time, he made no sales although he maintained his registration with the firm during the period. In spite of his lack of background in securities, he decided to start his own brokerage firm. His reasoning, in his own words, was as follows:

> I went back to work for American Diversified Securities, a corporation, in August 1960. I was there a period of 2 to 3 weeks. They were enjoined for bookkeeping violations.
>
> I had a choice of going back to the Bureau of the Census, going to work for some other broker, or starting a brokerage firm. So I started a brokerage firm.

Garey began his operation under the name of District Securities, Inc., with a total net worth of $3,625, including $1,500 in cash and the rest in "accounts receivable, securities, car [and] furniture." Garey was assisted in the handling of the details of establishing his firm by a former trader from ADS, a part-time accountant, and had the advice

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[11] The firm had previously set up an office in Philadelphia, which was suspended 5 months after its opening by the Pennsylvania Securities Commission and never permitted to reopen.

of other former ADS salesmen who had also become broker-dealers on their own.

In January 1961, shortly after the establishment of his sole proprietorship, Garey took on a partner, an about-to-retire Army officer named Leonidas W. Best, who in return for a 20-percent interest in the firm, subordinated his $5,000 customer's account to all other claims against the firm. The partnership was given the name of Best & Garey. Best, whose military experience had been primarily as an airplane pilot, had met Garey when they were both salesmen for ADS. When asked how he had been persuaded to invest $5,000 in a firm whose prospects did not appear, on the surface to be very bright, Best stated:

> I think the primary persuading factor to me was, No. 1, having been a customer in buying and selling stock and having been a part-time representative at ADS, I was generally interested in the stock market to begin with.

Another persuading factor may have been the profits expected from a regulation A underwriting which the firm was about to make of the stock of Visual Dynamics Corp. This issue and another—Chemionics Engineering Laboratories, Inc., also issued under regulation A a few days later—ultimately brought about the firm's demise. On May 25, 1962, the Commission announced that it had temporarily suspended the regulation A exemption of both these underwritings, stating that "the offering circular of each is false and misleading in respect of certain material facts." On the same day the Commission also announced that it had ordered proceedings to determine whether to revoke the broker-dealer registration of Best & Garey.[12] Shortly thereafter, on July 6, 1962, the Commission stated that it had revoked the firm's registration, expelled it from the NASD, and found the two partners to be causes of these actions.[13] According to the decision, both Garey and Best, during the period of January 1961 to September 1961, engaged in willful violations of the antifraud provisions of the Securities Act and of the Exchange Act by failing to make a bona fide public offering of the shares of these corporations in that they allocated "a substantial portion of the shares to a favored and select group of persons which included promoters and affiliates of the issuer and [their] relations and associates," by failing to make a reasonable inquiry as to the true nature and worth of these "unseasoned and speculative shares," and by making false and misleading statements about their other illegal activities and about the securities themselves. After making these findings, the Commission revoked the firm's registration as a broker-dealer, expelled the firm from the NASD, and found the two partners to be causes of these actions.

The salesmen serving Best & Garey included six—three of whom worked part time—whose previous securities experience had been with subsequently revoked firms, and five inexperienced salesmen—four part time—recruited from such occupations as the U.S. Army and the sale of used cars. None of these persons has since formed a broker-dealer firm of his own. Under present law, however, nothing has stood in the way of his doing so.

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[12] Securities Act release No. 4494, Securities Exchange Act release No. 6818.
[13] Securities Exchange Act release No. 6841.

(3) *Robert A. Martin Associates, Inc.*

Firms whose operations betray the characteristics of inexperienced, untrained, and even indifferent management are not confined exclusively to the over-the-counter market. The New York Stock Exchange devotes commendably extensive attention to screening prospective members as to their character and integrity, but has until recently been somewhat looser in assuring their competence.[14] This system has made it possible—although such occurrences have been quite infrequent in recent years—for the entry of firms whose subsequent methods of operation give reason to rue their initial admission. One such firm, which from the start of its brief career as an NYSE member organization acted in violation of rules of the exchange, the Federal Reserve Board, and the Commission, was Robert A. Martin Associates, Inc.

In February 1960, Robert A. Martin, then 22 years of age, approached the NYSE to purchase a seat for the purpose of conducting a general commission business with the public. Following the reference of his formal application to the subcommittee on admissions, the regular staff investigation by the exchange developed facts which raised serious questions as to Martin's qualifications to become a member and operate his own commission business. Prior to filing his application, Martin had been active in the market for his own account, financing about 80 percent of his transactions through unregulated lenders. In addition, the staff learned of various personal and financial difficulties in which Martin had been involved while a student at the university which he had attended. His prior business experience consisted of 4 months as a vice president in a textile company controlled by his father, who before his death in 1959 was a prominent businessman with substantial interests in several corporations. Martin had maintained active accounts with several broker-dealers in New York, a fact which led one of his sponsors to describe him as a "student of securities." This sponsor also conceded in testimony before the subcommittee on admissions that he had met Martin only five or six times in his life, and was not, as required by the exchange rules, a person who has "* * * known the applicant sufficiently well and over a long enough period of time that * * * [he] can unqualifiedly endorse the applicant from * * * [his] personal knowledge of him and of his business connections." After his appearance before the subcommittee, Martin received a copy of an essay-type registered representative examination then used by the exchange, which he was asked to take under the honor system. A few days after his admission he was told that he had passed with a grade of 81 percent, a low score for a principal of a member firm.

The circumstances developed regarding Martin's lack of experience, his age, the nature of his borrowings, and his financial and personal difficulties might have been expected to cause the exchange to reject his application, particularly in view of the fact that he planned to conduct a commission business directly with the public. Such circumstances in the case of an applicant to become a registered representative probably would have resulted in the denial of registration. Nevertheless, Martin's application was approved by the board of governors of the exchange on March 10, 1960. Approval was given at

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[14] The NYSE's controls over entry are discussed in detail in sec. 2.c, below.

the same time to the formation of the firm of Robert A. Martin Associates, Inc., whose voting stock was held by Martin and two others. Martin was the president and the holder of a predominant majority of the shares, and he directed the firm. At the time of his admission, Martin was one of the youngest broker-dealers in the country, and perhaps the youngest member of the New York Stock Exchange.

Almost immediately after his firm started doing business, in the last week of March 1960, Martin ran into difficulty in complying with exchange rules. Although organized with a capital of $120,000, the firm was in violation of the exchange's net capital rule by May 31, 1960. By that time it had also violated the Federal Reserve's regulation T, which restricts the use of credit in securities transactions.

In July 1960, exchange investigators found that the firm's customers' ledger and stock record were posted to a date 2 weeks prior to the current date rather than on a day-to-day basis as required both by the exchange and by rule 17A–3 of the Exchange Act. Other deficiencies in the firm's recordkeeping practices were also noted. In commenting on his withdrawing from the firm an amount which had the effect of placing the firm's capital below the exchange's minimum requirements, Martin said:

> Well, let me explain this; this particular situation came up and is entirely my fault. I would say most of it is due to my ignorance just in accounting procedures, and back-office procedures which I am not familiar with.

Upon first going into business the firm had had difficulty in securing salesmen, and since its overhead was sizable its initial losses were also considerable, amounting in June 1960 to $30,000. Among the activities undertaken to offset these losses was the best-efforts underwriting of a regulation A offering in which the total compensation (underwriting discount, expenses, and options) allocated to the firm was about 34 percent of the amount the public paid for the stock, a sum substantially in excess of the NYSE's "working practice" limiting maximum compensation to member firm underwriters to 15 to 20 percent. The firm also undertook heavy commitments in speculative over-the-counter stocks for its own account.

On September 14, 1960, the exchange notified Martin that the board of governors had considered his firm's May 31, 1960, violation of the capital requirements, and reprimanded him with a letter "reminding the members and allied members of your corporation of the importance of rule 325 [the capital requirements rule]." The letter also noted that the firm had violated the exchange's capital rule on two other occasions, one of them subsequent to the incident which was reported to the board of governors. Two days after its letter to Martin, the exchange learned that the firm which had been handling the Martin firm's clearing operations had requested it to transfer its accounts to another member organization, because a check written by Martin to their order for $10,100 had failed to clear the first time it had been presented.

Finally, after exchange investigators discovered other violations, including infractions of regulation T, the exchange's margin maintenance rule and the Commission's short-selling rule, Martin was "advised" by the exchange to sell his seat. He disposed of his membership on February 9, 1961, less than a year after he had started business as a proprietor of a member firm, but he continued for a time in the

securities business nevertheless.[15] On October 23, 1962, the New York regional office of the Commission announced that a Federal court order had been entered temporarily enjoining Robert A. Martin Associates, Inc., and Robert A. Martin, its president, from further violations of the Commission's net capital rule.

(4) *Albion Securities Co., Inc.*

Early disaster is not always the lot of new broker-dealer firms formed by inexperienced principals indifferent to the public interest. One firm, Albion Securities Co., Inc. (Albion), unlike the firms described above, was still doing business at the writing of this report and still presumably operating under its earlier attitudes of laxity and caveat emptor.

Albion was founded in September 1958 by two brothers, Murray and John F. Dailey, Jr. Murray, a businessman in Albion, N.Y. (whence came the firm's name) with a variety of interests including produce, sauerkraut canning, beer distributing, and the breeding, training, and racing of trotting horses, supplied the firm's total capital of some $10,000. The other brother, John, a practicing lawyer in New York City, has spent somewhat less than half of his working day as the secretary-treasurer of the corporation and the firm's chief executive officer. Each brother has been entitled to half of the firm's profits, which up to 1962 had not been sufficient to justify any distributions.

Albion was founded for the sole purpose of affecting the regulation A distribution of shares of Heliogen Products, Inc., a company in which the brothers had substantial financial interests.[16] In John Dailey's words, Albion was to be "just a firm to sell this one issue of Heliogen and then get out of the business."

Dailey had originally hoped to have the Heliogen issue underwritten by Ben Degaetano, who was then running a firm known as Midland Securities, Inc., but Degaetano and his firm were found to be under a disability for previous violations of the Securities Act and were thus forbidden to underwrite regulation A issues.[17] To sell the Heliogen stock for Albion, Dailey hired a salesman from Midland who brought two other salesmen with him. These persons had not been selling Heliogen to the public for 2 days before they discovered that already-issued stock of the same company was being sold in the over-the-counter market at half the offering price of the new issue. They thereupon left the firm and its unsalable merchandise.

In spite of this initial failure, Dailey decided to continue in the securities business and to secure a membership in the NASD, a step which he had not previously considered necessary. The decision was influenced, he said, by an attorney friend who told him that "* * * he had just written an offering circular [under regulation A] for an issue which he thought Albion could make some money on." The

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[15] There is no connection between this firm and its members and Robert Martin & Co., Inc., discussed in ch. III.C.

[16] John F. Dailey, Jr., was a vice president and treasurer, while his brother was a "heavy investor."

[17] The NASD's expulsion of Midland Securities, Inc., for sales of securities at unfair prices and failure to maintain records, was sustained by the Commission on Nov. 16, 1960. Degaetano, its president and sole stockholder, was named a cause. Securities Exchange Act release No. 6413. Midland's broker-dealer registration was revoked in another Commission decision dated Apr. 10, 1961, for false and misleading statements in the sale of securities. Securities Exchange Act release No. 6524.

substance of the advice which Dailey received at this time he recalled to be as follows:

> Well, people I talked to, that I had some confidence in, told me that if you are careful about the cashier or bookkeeper, and have confidence and trust in them, that the operation of an underwriting house, a securities house, was not a great problem, and that there was room in the field to make a substantial amount of money honestly, and it should not impose itself too much on my time as an attorney.

Accordingly, Dailey filed an application for membership in the NASD, and he and his brother (who remained in Albion, N.Y.) were required to take the association's examination for registered representatives, since Murray had had no experience in the securities business, and John's was limited to underwriting the abortive Heliogen offering and filing offering circulars for a few regulation A issues. At the time—1959—the NASD's examination was based on questions from previously supplied compilations of questions and answers, and the Dailey brothers had no difficulty in surmounting the hurdle. According to Dailey:

> I studied the book quite thoroughly and I think my mark was 98, and my brother, who had had even less experience than I had had, did not study at all and had 99.

Dailey conceded that he "didn't know a great deal about the distribution end of the business" and his next move was to hire a manager and "let him take over the operations of Albion Securities Co." In his words:

> * * * [M]y thought at the time was that you get a good manager in there and a good cashier and the business will pretty much take care of itself and then I can practice law.

A man was recommended to Dailey as manager who had been "successful" in the securities business and had run his own firm, and who could bring with him "a couple of men that were always with him." Dailey says that he looked into the prospective manager's background by checking with the New York regional office of the Commission and talking to "one or two people that knew him or had some experience with him," but does not recall knowing that this individual had been convicted of fraud in the sale of land in Florida some years before, and also had been associated with several broker-dealers which had been subject to Commission disciplinary action.

The qualifications of the salesmen included in the package deal were no better than those of the new manager. One had spent the preceding 7½ years working for eight broker-dealer firms (including 5 years with a firm of which Dailey's new manager had been proprietor), the registration of five of which had been revoked by the Commission, and the principals of two of which had been named in indictments for crimes relating to securities.

Dailey's second selling team was not much more successful than his first had been, and disposed of only two-thirds of the offering of shares of Scaico Controls, Inc., the regulation A issue for the distribution of which (on a best-efforts basis) Albion had remained in business. After 3 months, the team departed.

In June of 1960, Dailey again reconstituted his sales force, this time hiring the two-man sales-management team of Anthony Gravino and Lewis Cohen. Before working for Albion, Cohen and Gravino

had worked as comanagers at Pinsker & Co., Inc., and at Palombi Securities Co., Inc., both of which had had proceedings instituted against them by the Commission for the fraudulent sale of securities.[18] Cohen, in addition, was still under a temporary restraining order in an action brought by the Commission to enjoin further sales of stock in Atomic Mining, Inc., by Scott, Taylor & Co., a broker-dealer firm for which he had worked. The Commission's complaint in this action (which has since resulted in a permanent injunction [19]) alleged that the defendants, including Cohen, used false and fictitious names and made false and misleading representations in long-distance telephone solicitations.

In the Special Study's public hearings, Dailey was questioned as to his motives in hiring persons with records such as these.

Q. Didn't this bother you when you hired these folks, Mr. Dailey?

A. I don't think it gave me great concern. Well, it probably gave me some concern, but I liked these fellows. They impressed me as being all right. The fact that they had been * * * salesmen for firms against which proceedings had been instituted, * * * I thought that if I filed an application for approval with the NASD and gave all the information that was requested and required, and I did everything that I was required to do under the NASD rules, and they were approved as salesmen, that I was fairly safe in hiring them, especially when I would be on the ground and in constant daily contact with them.

Earlier, in a private hearing, Dailey had been asked:

Q. Didn't you think that possibly some of the methods of doing business of some of these other firms might not [sic] rub off on Mr. Gravino?

* * * * * * *

A. I don't recall giving that any thought. Gravino impressed me. I had a number of conferences with him.

Gravino and Cohen were given authority to organize a sales force. Their efforts resulted in the hiring between June 1960 and May 1962 of some 50 salesmen, with "seven or eight" full-time and "four or five" part-time salesmen being employed at any one time. The backgrounds of many of these salesmen were no more reassuring than were the managers' records. Dailey, however, was not "too much concerned" with the reputations of the firms for which a prospective salesman had worked, for "the fact that he might have worked for a firm that had had difficulties with the NASD or the SEC—I wouldn't necessarily attribute to the salesman's fault." At the same time, Dailey noted that he sought persons who—

in their relationships with their customers or clients would not make any representations which in any way would reflect on Albion or get Albion into any difficulties with the SEC or the NASD.

However, he made no independent inquiry into the character of the firms they had been involved with, nor into the outcome of Commission proceedings against them. He testified that, by and large, he relied on the recommendations of friends or employees in assessing a would-be salesman's good character, to which he was required to certify under the NASD rules. In some instances, this reliance meant that Dailey would give his certification after an acquaintance of only a few minutes' duration. In his words:

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[18] Pinsker has since had its registration with the Commission revoked. Of the five firms in which Cohen and Gravino had worked together before joining Albion, four have since been revoked by the Commission, while the fifth has been expelled from the NASD.

[19] Litigation release No. 2406 (Oct. 23, 1962).

I mean they [the prospective salesmen] would be brought in and introduced to me, and I would discuss it [employment with Albion] with them and get somebody's recommendation or talk with somebody and fill in the application and send it in.

There may have been occasions, Dailey conceded, when he had not even met a salesman for whom he signed an application.

Dailey did not insist on experience in his salesmen, but looked for—

* * * boys or men that either have had experience or that are apt to be able to dispose of underwritings or participations to friends or acquaintances of theirs, people who want to get in the business.

In addition, Dailey wanted persons of "intelligence and character" who are able to sell over the telephone to persons they did not know. Although in its hiring the firm purportedly did not emphasize that particular ability, salesmen who could not sell in that manner would be quickly discovered, and, in the words of Dailey, "if he could not, that would mean he could not make any money and he would leave the business, or we would suggest to him that he go back to some other line."

The firm provided no training program "other than Mr. Cohen or Gravino telling the salesmen, if they are new salesmen, that any questions that they want to ask on anything they don't understand, feel free to approach and ask them." Dailey added:

No; no training program, no program as such. * * * In the case of new salesmen that had not been in the business before generally, Mr. G [Gravino] would tell them, "I will be right here, available at all times." Maybe he would explain the salesman's role for 15 minutes, a half hour, an hour, and advise them to sit around and listen to other salesmen for 4 or 5 or 6 days. I don't mean by this to say that they wouldn't sell for 4, 5, 6 days, but I know in some cases while a man was waiting for his registration to become effective [that he would wait that long] * * * Mr. C. [Cohen], when the occasion arose and time was available, would sit down with them and tell them about the securities business, the underwriting business, and how far one could go in trying to sell stock over the telephone. * * * If he [the new salesman] seems to know the business, is anxious to sell, has been around and listened to what goes on, he would be qualified to sell immediately.

Salesmen representing striking extremes entered the firm under the Albion hiring criteria. One, a William Perles, was later discharged by Dailey because—

* * * I was not pleased with the tone of voice that I heard. It sounded as though there might be some kind of pressure selling, argumentative, aggressive * * * He proved to be an aggressive type individual.

Had Dailey examined Perles' record closely, he would have had ample warning that the man might engage in aggressive selling tactics, for his previous employment in the securities business had involved an extraordinary string of firms, including some of the most famous boiler rooms of the last decade. Perles' NASD record as of December 1962 showed 34 separate periods of employment with 32 different firms, of which, according to Commission files, 10 had been revoked and 6 others made subject to various proceedings and actions, including one firm in which the principal had been convicted of violations of the securities laws.[20]

On the other end of the scale of experience was one D. Richard Engel, who was recruited by Gravino from the sales force of a vacuum

[20] Salesmen's turnover is discussed in pt. C.1.c, below. See also pt. C.3.c(1), below.

cleaner distributing company. Engel described his first encounter with his future employer:

I went to his [Gravino's] house and I sold him a Kirby [vacuum cleaner]. And he told me that with my potential I could do very well in the brokerage business.

* * * * * * *

Well, he liked the way I talked. He said that if I worked that hard selling stock as I did with the Kirby, I would do pretty well. And at the time I wasn't giving much thought about the brokerage business, because I knew nothing about it.

With no training and no knowledge of securities, Engel passed his NASD examination and was turned loose on the investing public. When asked if he could read a financial statement, he replied:

Not really, except I learned a few words like "current ratio." Certain things I looked for myself. Not that it means anything, because I am far from an analyst.

Engel joined the firm in September 1960, the beginning of a period of intense public interest in the over-the-counter market, and he became enthusiastic over the market performance and prospects of some of the "merchandise" he was given to sell.[21] As he later recounted, he brought imagination and drive to his efforts to sell shares of Edlund Engineered Products, Inc. (Edlund), one of Albion's first underwritings.

* * * [T]hat was the first big number I had, and for me, a new man, 20,000 shares I sold. I went to the Chinese restaurant in my neighborhood. I sold him stock of Edlund.

I went to my paperhanger, my painter. I went out with a girl; I sold stock to her. I called up one of my customers. I couldn't get him on the phone. The telephone operator answered; I sold her Edlund. That was my big thing.

* * * * * * *

Girls I went out with I hung. I went to my dentist and I used to think he overcharged me every time I went there and I sold him Edlund. Everybody I came in contact with.

* * * * * * *

To me I was led to believe it was the most fantastic thing. I was led to believe—it was the first underwriting I ever had.

The price of Edlund stock rose sharply and quickly shortly after it came on the market, as did the prices of other stocks distributed by Albion, and for a while Engel's customers had "winners." As he remembers it:

People just were buying; it was a new issue and it was like a crazy fad, more or less, and everything they bought it was a winner just because of the circumstances. * * *

* * * * * * *

* * * I was making a fairly nice living—more than I ever made before—but suddenly a change came. I think it was last May [1961] when—poof!—everything went just down the drain.

The disintegration of the new issue market, first noticeable in the summer of 1961, caused severe harm to many investors in securities recommended by Albion. Edlund, whose common stock was originally offered at $3 a share, is now in bankruptcy. Another Albion underwriting, International Marine Industries, Inc., was first offered

[21] Albion's practices in selling speculative over-the-counter securities are discussed in ch. III.B.4, below.

to the public at $4, and was quoted at three-eighths bid, five-eighths offered on March 15, 1963. On the other hand, a third underwriting, Energy Components, Inc., originally offered at 3½, was being offered, at approximately that price in March 1963. Albion also participated, as a selling group member, in the distributions of approximately 45 new issues in 1961 and 1962. As of March 15, 1963, 32 of these stocks were being quoted at 50 percent or more below their initial offering prices or were not being quoted at all, while only 5 of these issues appeared at or above the prices at which they were first sold.

Engel's customers were among those hit hard by these price declines. He recalled the sales he made to one of his customers in the following manner:

One of my best customers, and I finally lost him.

* * * * * * *

I don't blame him either. I mean, the guy was a good account of mine, very good account. He had complete faith in me * * *. You don't find many like him; he wasn't a tremendous account but he was a good account. He never bothered me with quotes. He never gave me a hard time.

And he bought a lot of stocks [11 issues] with me. Almost everything I recommended, because he trusted me and I would never hurt a man like that, because he was a nice fellow.

* * * * * * *

[T]hat man has been hurt so bad, it's amazing.

Q. What business is [he] * * * in?

A. He is a druggist, I believe * * *. He is a young fellow, younger than myself, but he seems like a young gentleman, nice fellow. And everybody's unhappy about it. I don't blame them.

b. General problems of qualifications of broker-dealer principals

(1) *Firms in general*

Since there are substantial numbers of broker-dealers entering and leaving the securities business every year,[22] the adequacy of the preparation which the new men bring to their business is of critical importance to the securities industry. The study analyzed the prior experience of the principals—proprietors, partners, officers, and large stockholders—of new broker-dealer firms registering with the Commission during the first 3 months of 1961 (table II-1). Experience was measured in terms of employment by, or other business connections with, a registered broker-dealer. Even under these broad standards, which give equal credit to full- and part-time employment and make no distinctions as to the type of work done, a large number of broker-dealer firms entered the business without experienced principals. Thus, almost 28 percent (58) of the 210 firms whose applications were examined included no experienced persons among their principals, and over 50 percent of the firms were in the hands of persons with under 2 years' experience.

When examined as individuals apart from their firms, persons serving as principals revealed an even greater degree of inexperience. Of the persons guiding the new firms, 54 percent (300) had no securities experience at all, while about 73 percent (408) had less than 2 years' experience. In most of the cases in which there had been some experience, it consisted of time spent selling securities. Very few persons appeared to have had back-office experience, although some had been security analysts, traders, or office managers.

[22] Statistics on the size of the broker-dealer portion of the securities industry are contained in ch. I.B, above.

The dangers inherent in admitting inexperienced persons into the securities business as operators of their own firms were brought out in the study's analysis of NASD disciplinary actions against its member firms, and their disposition. The analysis related disciplinary actions in the years 1959 through 1961 to the years in which the subject firms had first become members of the NASD (almost always the year of entry into the business). The results of this analysis revealed that the association's newest member firms, which are generally controlled by persons having less experience than principals of older firms, were responsible for a heavy preponderance of the offenses drawing the most severe penalties (table II-2).

In recent years, between 20 and 25 percent of all member firms of the NASD have been members for less than 2 years; firms which became members before 1941 have comprised approximately the same percentage of the total NASD membership. The study analysis showed that although only 14 percent of the firms involved in NASD disciplinary actions had entered the NASD in the most recent 2-year period (1959–60), 45 percent of the firms which had been expelled fell into this new-firm category (table II-2). On the other hand, firms which had become members before 1941 accounted for 37 percent of the firms against which disciplinary action had been taken but for only 2 percent of those expelled, and almost 25 percent of the older firms had had the charges against them dismissed. Altogether, almost 53 percent of the new firms involved in actions had received one of the most severe penalties imposed by the association (suspensions and expulsions, with and without fines), while less than 2 percent of the oldest of the firms received such penalties. For firms with membership dates between these two extremes the data reveal a tendency for the age of the firms and the severity of the penalties to be related. The inferences to be drawn from the severity of the penalties involved may be limited by the possibility that NASD district business conduct committees deal more leniently with their older members, but even after due allowances for such a possible bias the contrast is striking.

The types of offenses causing the imposition of penalties on newer firms often appear to be attributable to their principals' lack of familiarity with the technical and financial aspects of the business. These firms showed a distinctly higher incidence of violations of the net capital rule and provisions relating to the proper maintenance of books and records than did the older firms, 32 percent of whose violations involved "free riding"[23] which the NASD considers minor (table II-3).

Another study analysis—of the NASD staff's inspections of members' premises in the New York City area during the last 3 months of 1961—similarly showed a high incidence of alleged violations among newer members, particularly with respect to net capital violations and faulty books and records. Firms whose membership had begun in the years 1958–61, while amounting to 36 percent of those examined, accounted for almost 50 percent of the alleged violations, including all of those relating to financial condition, and 45 percent of those concerned with books and records. By far the most fruitful of these examinations, in terms of the number of violations found,

[23] "Free riding" is discussed in ch. IV.B.3.b(2)(f).

were those in which a firm was inspected for the first time. Although many such first examinations were conducted several years after the firms joined the association, a very high percentage of all violations arose out of these initial examinations.

The concern of certain members of the securities industry for the lack of qualifications of many new entrants to the business and their propensity for involvement in securities violations was expressed by the members of NASD District Committee No. 12, whose jurisdiction extends over New York State and northern New Jersey, in a unanimously approved resolution dated January 16, 1962. The resolution stated, in part:

Whereas we have had to deal with an increasingly high rate of influx of proprietors, officers, partners, and other personnel who are unqualified by reason of lack of proper moral attitudes, inadequate training and experience, and insufficient capital funds; and

Whereas experience has shown (1) that this group actually becomes involved at a disproportionately high rate in infractions and (2) that these infractions stem directly from the inadequacies mentioned; and

Whereas, because of this, the business conduct committee in this district has found it increasingly difficult within the present framework to enforce high standards of commercial honor and just and equitable principles of trade in such manner as to adequately protect the public interest: Now, therefore, be it

Resolved, That this district committee strongly urges the board of governors to supplement the recent salutary strengthening of the examination procedures by the adoption of ways and means designed to provide for the establishment of a more rigid set of qualification standards in the areas of character, experience, and financial responsibility, preferably as a prerequisite to membership and/or registration. In the alternative, we urge the adoption of any other medium reasonably designed to effectuate the overall purpose of limiting access to the business in any capacity, to those patently unqualified in the areas mentioned.

(2) *Firms engaged in underwriting*

The Special Study analyzed the prior experience of the principals of all managing underwriters of unseasoned common stock issues offered to the public in 1961. While the results of this analysis are set forth in greater detail in chapter IV.B.2.b(1) below, the high incidence of inexperienced firms and principals in this very demanding and technical area of the securities business is worth noting here. Of 503 such underwriters, more than half had been organized less than 6 years before the underwriting, more than one-fourth in 1960 or 1961 (table IV–17). Of this last group of 146 new firms, 44, or 30 percent, had no principal with more than 2 years' experience in the securities business. Of the new group, 66, or 45 percent, had net capital of less than $10,000, 87 percent had less than $100,000, and none had $500,000 or over (table IV–18).

As might be expected, these new firms concentrated their activities on regulation A offerings and best-efforts underwritings, which separately and especially in combination characteristically involve smaller amounts of money, less financial risk for the underwriter, and greater speculative risk for the investor. For the group, 67 percent of the issues underwritten were regulation A offerings, compared with 21 percent for all firms organized before 1956 and 40 percent for all underwriting firms (table IV–20); 65 percent were handled on a best-efforts basis, compared with 15 percent for the older firms and 38 percent for all firms (table IV–19). Experience alone, of course, does not indicate responsibility on the part of an underwriter, but the concentration on highly speculative issues by new firms with

inexperienced principals and modest capitalization is a matter for concern.

A recent Commission decision issuing a stop order suspending the effectiveness of a registration statement of the Richmond Corp. has emphasized the importance of experience for an underwriter. The managing underwriter, in an offering filed with the Commission on December 21, 1961, proposed to sell $1 million of common stock on a "best-efforts" basis, but informed the issuing corporation that, because of its limited experience in underwriting and its limited number of customers, it would probably not be able to sell more than $300,000 of the total offering, and that it would have to form a selling group to dispose of the rest—an action which it never took. The underwriter was a sole proprietor whose only securities experience prior to the formation of his own firm early in 1961 had been 7 months spent as a salesman. His underwriting experience had consisted of two offerings. One, of which he had been the underwriter, had been deregistered by the Commission shortly after its registration had become effective. The other in which he was counderwriter, was a small regulation A issue. In its opinion the Commission said that the "inexperience of the underwriter is a material factor bearing on the probable success of the proposed offering and the failure to disclose it was a material omission" from the registration statement.[24]

2. CONTROLS OVER ENTRY INTO THE SECURITIES BUSINESS

Simple though it is for almost anyone to enter, there are few areas of the securities business where a broker-dealer can operate without at least registering in advance with one or more regulatory agencies. The overlapping authorities which have some measure of jurisdiction over those who elect to carry on a securities business include the Commission, the NASD, the registered national securities exchanges, and all States but Delaware and Nevada, and the District of Columbia.[25] The collective effect of this pattern of regulation is to leave totally free only a limited number of broker-dealers who do business solely in securities exempted by all authorities or who confine their activities exclusively to the three jurisdictions without blue-sky laws.

On the other hand, so far as controls over entry into the securities business are concerned, the pattern of regulation is broad in coverage but creates only low barriers. For the Federal Government, the barrier to entry, conditioned as has been noted by the philosophy of free access, is marked only by the concept of registration, a status open to an unlimited number of participants so long as they have not been previously acted against by the Commission or have not committed violations of laws and rules involving securities. For the NASD, the same philosophy controls, though a selective procedure based on examinations places its threshold at a slightly higher level. The majority of the States similarly require no more than registration, though in the exercise of their police power, a number have adopted higher standards. For most purposes registration with the Commission and the State in which business is to be conducted, and membership in the NASD, are the only prerequisites to launching

[24] *The Richmond Corporation,* Securities Act Release No. 4584 (Feb. 27, 1963).
[25] Further discussion of the coverage of State law is contained in sec. 2.e, below.

a securities enterprise, and the public gets small protection at the point of launching from these sources. The exchanges, with their limited memberships, may be more selective, but exchange membership is not necessary for many firms.

In discussing controls over firms which are entering the securities business, it is useful to bear in mind that some rules relate perforce to the entity which will carry on business, while others relate to the individuals who as principals or other owners make up that entity. Rules in the latter category are those designed to eliminate from the securities business persons of doubtful integrity or inadequate knowledge and experience.[26] Even though Commission registration and NASD membership are framed in the context of the business entity, they go to the individuals behind the entity by conditioning registration or membership of the firm upon the compliance with their standards by the principals and other persons connected with the firm. The major exchanges, though usually requiring that members be individuals, achieve the same end by subjecting to their approval all nonmember partners or other principals of the firms with which their members are connected.

On the other hand, certain of the authorities have rules relating to financial capacity which are concerned with the broker-dealer firms as a separate entity. These require that a firm have a certain amount of capital, or be bonded in a specified amount for the protection of persons who deal with it, not only before the firm can commence doing business, but also throughout its life.[27]

a. Federal controls—the Securities and Exchange Commission

Brokers and dealers making use of the mails or of any means of interstate commerce to induce or effect transactions in any security (other than various types of commercial paper and exempted securities such as municipal and Government bonds) are generally required to register with the Securities and Exchange Commission.[28] Although brokers or dealers confining their activities solely to transactions on a national securities exchange or doing exclusively an intrastate business or dealing only in exempted securities, are not required to register, few securities firms fail to register, if only as a precautionary measure, except for a small number of specialists, floor traders, and others doing no business with the public. The unregistered firms not subject to exchange controls are believed to be of limited significance in their effect on public investors, whether considered separately or as a group, since few firms could have many customer accounts

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[26] Such rules are discussed in this section insofar as they apply to principals of broker-dealer firms, and in pt. C.3, below, as they are applicable to salesmen.

[27] Controls over financial responsibility which are directly related to the day-to-day operation of a firm, such as rules requiring the maintenance of a certain ratio between aggregate indebtedness and net capital and rules governing the use of customers' securities and free credit balances, are treated in ch. III.D, while the desirability of a minimum capital requirement is discussed in sec. 3, below.

[28] Prior to a 1936 amendment to the Securities Exchange Act setting forth the requirements, the Commission provided much the same standards of registration through rules adopted under the original act, which gave the Commission broad rulemaking power for the regulation of firms "making markets." See 2 Loss, Securities Regulation 1150, 1288–89 (1961).

The language of sec. 15(a) of the Exchange Act follows:

"No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsec. (b) of this section."

without being required to register with the Commission. With the exception of firms dealing solely in Government or municipal bonds, the broker-dealers outside the Commission purview are primarily small firms transacting business in local bonds or other securities.[29] As for the firms which do come within the Commission's jurisdiction, there were, as of December 31, 1962, 5,724 registered with the Commission, a decline from the postwar high of 5,868 reached on June 30, 1962. The alltime high was 6,809, as of June 30, 1938.

Although the Federal statute does not limit the number of dealers who can register, the door is not quite open to all. Registration is denied, unless the Commission grants a special dispensation on grounds of "public interest," to firms which are controlled by, or which employ or otherwise control persons who are subject to certain disabilities specified in the statute. Individuals whose prior conduct will result in barring a firm from registration include persons who have been convicted of certain Federal or State offenses relating to securities within the last 10 years, are permanently or temporarily enjoined from engaging in any conduct or practice related to the purchase or sale of securities, or have been found by the Commission to have been in violation of either the 1933 or 1934 Federal securities acts or the rules thereunder.[30] These statutory bars are broad in their effect, since a statutory bar applicable to almost anyone connected with a firm is an almost insurmountable obstacle to the registration of the firm.

However, the coverage of the restrictions themselves is limited. Conviction of other crimes, such as embezzlement and fraud unrelated to securities, though not disqualifying under the statute, may indicate as much potential danger to the investing public as the securities offenses now listed in section 15(b), and disciplinary sanctions imposed by the national stock exchanges or the NASD, even though resulting from misconduct involving securities transactions, do not preclude registration by the Commission.[31]

The Commission uses primarily two devices to enforce the exclusionary provisions of section 15(b): First, a registration application form, and subsequently, periodic inspections of the firms' books and records. The application for broker-dealer registration, form BD, in use since 1954, is less than a comprehensive document. It requests information, in addition to the name and address of the prospective registrant, concerning (1) the full names of all officers, directors, partners, and persons owning 10 percent or more of any class of stock, together with persons exercising direct or indirect control over the business of the applicant, and for general partners not residing in the United States, the addresses of their residences; (2) for each person falling within the categories listed above, the exact nature of any connection or interest he had, within the previous 10 years, in any broker-dealer firm other than the present applicant or its predecessor; and (3) information as to whether any of the persons referred to

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[29] In addition to the local firm referred to here, and as is indicated below in sec. 2.e, on State control, the blue sky laws of many of the States require the registration as "broker-dealers" of many persons and firms, such as issuers of their own shares, which are not required to register under Federal law.

[30] Sec. 15(b), Exchange Act.

[31] Proposals were included in prior legislative programs which would have amended the section to include, as offenses precluding registration, embezzlement, fraudulent conversion, misappropriation of funds, securities or other property, and violation of 18 U.S.C., secs. 1341–1343 (the mail fraud, fictitious name, and commercial fraud statutes).

above, "any salesman or other employee, or any other person directly or indirectly controlling or controlled by registrant" has committed any of the offenses enumerated under section 15(b). A statement of financial condition of the registrant firm is also required.[32]

In addition to information requested by the present form BD, the predecessor form 3-M called for the addresses and names of managers of all branch offices; the number of salesmen, traders, customers' men, and other employees; information on whether the firm carried margin accounts, extended credit, or accepted securities for safekeeping; and the firm's membership in securities exchanges or associations of brokers, dealers, or investment bankers. When these items were eliminated in early 1954, the Commission stated that the new form BD was "limited to the information necessary to determine whether or not the registrant * * * is subject to a disqualification within the meaning of section 15(b) of the [Exchange] Act." [33]

Form BD succeeded admirably in fulfilling its draftsmen's purpose of "eliminating duplication" and "simplifying requirements," but experience in recent years compels the conclusion that the pruning operation may have been too severe. Although prior to 1954 little use may have been made of the information eliminated, the study has amply demonstrated the need for filing with the Commission of information of the type formerly included in form 3-M, such as addresses and names of managers of branch offices, numbers of salesmen, and activities engaged in by the firm as well as additional information, such as the size and composition of research departments [34] and the names of persons in charge of various firm activities. Certain information formerly requested, such as exchange affiliation, and number and location of branch offices, is now available through such private sources as the Security Dealers of North America manual, but much of the information is nowhere publicly available.

The BD forms filed with the Commission are checked against its records, and if it is determined through admissions contained in the form or through investigation of persons connected with the firm that any of the bars of section 15(b) may apply, the Commission has several choices: It can determine that the public interest does not require that the firm's registration be denied or, if registration has already taken effect, that it be revoked. Alternatively, after opportunity for hearing, the Commission can deny or revoke or can, "upon such terms and conditions as [it] may deem necessary for the protection of investors," allow a firm to withdraw from registration.

In three cases decided in November 1962,[35] the Commission indicated a tightening up of its administrative practices relating to broker-dealer applications for registration. In denying registration to two firms and revoking registration of a third for incorrect statements in their applications, the Commission commented on "an unwholesome and impermissible lack of appreciation" of the importance of the applications and "a loose and careless attention to [their] accuracy and completeness." Because of the contributing negligence of counsel in two of the cases, the Commission withheld

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[32] Rule 15b-8, Exchange Act.
[33] Securities Exchange Act release No. 5000 (Feb. 14, 1954).
[34] See ch. III.C. below, on adequacy of research staffs.
[35] *S.A.E. Corporation, Astor Securities Co.*, and *R. J. Cunningham & Co., Inc.*, Securities Exchange Act release No. 6956 (Nov. 28, 1962).

findings that the individuals involved were causes of the violations, but served notice that it would consider similar future instances of inaccuracies or deficiencies in the light of the explicit admonitions in the opinion.[36]

The Commission's second tool in excluding broker-dealers subject to statutory bars lies in its power to require retention of records by registered broker-dealers.[37] While most of the records which must be kept relate to financial matters[38] and the nature of the business conducted by the firm,[39] the Commission in 1961 promulgated rule 17a-3(a)(12), which requires that records be kept of the business and educational histories of every person handling funds or soliciting transactions for a firm or supervising others in these activities. These records allow a check to be made on the information contained in the application for registration during the Commission's regular broker-dealer inspections.

Although the statutory bars set forth in section 15(b) of the Exchange Act relate to the character of the individuals connected with broker-dealer firms, there is no specific statutory provision on the establishment of controls by the Commission over the knowledge or competence of proprietors or other persons. However, there is provision for rules with respect to financial responsibility, as is described in section 3 below and chapter III.D.

b. The National Association of Securities Dealers, Inc. (NASD)

Membership in the NASD is not a legal requirement for firms engaged in the securities business. Nevertheless, rules of the association, sanctioned by Federal law, preclude a member firm from dealing with a nonmember firm except on the same terms and conditions as those employed in dealing with the public. These rules make membership an essential to engage profitably in almost any underwriting and in most over-the-counter business. Since most broker-dealers transact such business, the vast majority—4,771 as of December 31, 1962—are members, and most new broker-dealer firms must meet the association's membership requirements. While many of the nonmember firms do not do a significant business with the public, there are many others, such as those whose business is confined to the exchanges, certain large, integrated mutual fund sales organizations, firms handling real estate limited partnership interests, and all put-and-call dealers, which are not NASD members.

As a national securities association registered with the Commission under the Exchange Act,[40] the association is generally required to admit to membership any broker-dealer engaged in interstate transactions over the counter, except for those subject to stated statutory bars. The statute does, however, permit securities associations to impose restrictions on membership on a geographic basis or on the basis of the type of business done by its members, "or on such other specified and appropriate basis, as appears to the Commission to be necessary

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[36] The Commission has recently begun to enclose separate notices with broker-dealer registration applications calling attention to its requirements that all answers be "accurate, complete, and truthful," and that all information be kept current and amendments filed promptly to correct "information no longer accurate."

[37] Sec. 17, Exchange Act.

[38] The use of these records in upholding requirements of financial responsibility is discussed in sec. 3, below.

[39] Enforcement by the Commission of Federal statutory provisions covering selling practices is considered in ch. III.B.6.b, below.

[40] Exchange Act, sec. 15A.

or appropriate in the public interest or for the protection of investors * * *." [41] The statutory bars which enable the association to exclude a firm from membership apply not only to the firm itself but also to its partners, officers, directors, branch managers, and "any person directly or indirectly controlling or controlled by" the firm, including employees, "whether prior or subsequent to becoming such." [42] Disqualifications include (*a*) suspension or expulsion from a registered securities association or a national securities exchange for conduct inconsistent with just and equitable principles of trade, (*b*) denial or revocation of broker-dealer registration by the Commission, and (*c*) being named a "cause" for any such suspension, expulsion, denial, or revocation.

Until 1956, the association consistently followed an open-door membership policy, with the exception of its unsuccessful 1942 proposal of a minimum capital requirement.[43] Up to 1956, the requirements of membership in the association and registration with the Commission as a broker-dealer had been substantially identical, although the open-membership policy had frequently been the object of criticism from within the association. As early as 1941 the chairman of the board of governors had stated in a public address:

> * * * this may sound idealistic—the time may come when we can arrive at a more professional status and we can give more of our attention to setting up standards as to who should be in the investment business.

Several years later, in 1953, the NASD News noted membership concern with admissions standards:

> Growth in membership is not viewed by district committees and the board of governors as an unmixed blessing. It is expected that some people have joined the association for what they can get out of it and without the right kind of understanding of what is expected of them as members.
>
> As is often pointed out, a guy can hang out a securities business shingle for what it costs him to have the thing made. If he aspired to be a barber, he'd have to go to school and pass a test before he could get a State license to bend people's ears.[44]

In 1955 the association undertook the beginning of a program designed to elevate the standards of entry into the securities business. The changes consisted of three new disqualifying clauses in the association's bylaws in addition to the three mentioned above; the new clauses went into effect in 1956, following approval by the Commission. One of the new disqualifications gave recognition to one of the logical consequences of the registered representative concept initiated in 1946 [45] by excluding a person whose registration has been suspended or revoked by the association or a national securities exchange for conduct inconsistent with just and equitable principles of trade. The other two clauses bar persons who have been convicted within 10 years "of any felony or misdemeanor involving the purchase or sale of any security or arising out of the business of a broker or dealer" or of any felony or misdemeanor "which the association finds involved embezzlement, fraudulent conversion, misappropriation of funds, or abuse or misuse

[41] Exchange Act, sec. 15A(b)(3).
[42] Exchange Act, sec. 15A(b)(4).
[43] See pt. B.3, below.
[44] NASD News, July 1953, p. 3.
[45] The NASD's registered representative program is described in pt. C.3.b, below.

of a fiduciary relationship."[46] Perhaps the most significant parts of the association's program, however, were its first experience requirement for proprietors of broker-dealer firms and an examination for those proprietors who did not meet the experience requirement. The bylaw amendment[47] prohibited admission to membership of a broker-dealer firm where the sole proprietor or any general partner, officer, or controlling person active in the business had not been engaged in the securities business for a period of 1 year in some such capacity, unless that person passed a written examination. Unfortunately, the experience and examination requirements had no discernible effect as a screening device. The required examination was that given to all registered representatives[48] until January 1962. Its inadequacies are discussed below.[49]

In 1962, however, the board of governors authorized the development of a new examination designed for proprietors, partners, and officers of broker-dealer firms, which when ultimately put into use, may become an effective test of the knowledge and competency of such persons. Association officials have indicated that all partners, officers, or sole proprietors not exempted because of prior experience will be required to take the examination, which they anticipate will be substantially more difficult than the registered representative examination on the theory stated by 1962 Association Chairman Avery Rockefeller, Jr., that "those who are supervisors or running a business should know considerably more than, say, a registered representative."[50] It appears, however, that the association's committee on qualification examinations does not contemplate recommending any different experience requirement from the 1 year now required for exemption from the registered representative examination.

As part of its admission procedure, the association requires that firms apply on a form which requests considerably more information than that required by the Commission's form BD. Additional items include the address of each branch office, the States in which the firm is registered, the exchanges of which it is a member, and the type of business in which it is engaged and intends to continue. The form, which must be certified as true and complete by the applicant, also calls for a complete résumé of the business experience for the last 10 years of each applicant firm's partners or officers, a statement of its financial condition, and a statement of any facts which might constitute grounds for disqualification.

The association checks each application against its records but makes no other verification of the information contained therein. Accordingly, some matters which may constitute disqualifying facts and which would not normally appear in the association's files may escape its attention. The bylaws provide, however, that the application be referred to the NASD committee for the district in which the firm has its principal place of business and that if a majority of

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[46] NASD bylaws, art. I, sec. 2(a).

[47] NASD bylaws, art. I, sec. 2(b).

[48] The term "registered representative" under the NASD's bylaws, embraces all officers and partners of member firms (except those not controlling a firm's policy or handling customers' accounts), in addition to salesmen. NASD bylaws, art. XV, sec. 1.

[49] See pt. C.3.b(2), below.

[50] At the Special Study's public hearings, Rockefeller also mentioned a proposed examination for "registered representatives with less than a required amount of time in the business who are promoted to areas of supervision such as branch office managers." This proposal is discussed in greater detail in pt. D.3.b, below.

that committee's members is satisfied that the applicant is qualified through adequate experience and clear record, it shall approve its admission. The efficacy of this referral procedure is limited, however. As one district committee defined its authority:

It is the committee's understanding that it has no power or discretion under the bylaws to pass upon an applicant's character, integrity, or standing in the business, as such, and that if the applicant possesses the qualifications for membership as set forth in article 1, section 1 [defining eligible broker-dealers] and does not fall within the provisions of article 1, section 2(a) [listing the disqualifying bars], and said applicant's application is properly filled out and executed, the committee is required to approve said applicant's admission. * * *

The principal value of the districts' handling this review, which is usually delegated to paid district secretaries, lies in their access to adverse information in the possession of local State authorities. Also, committees are able to order early inspections of new member firms which appear to be less clearly qualified.[51]

c. The New York Stock Exchange

While memberships in the New York Stock Exchange are held by individuals rather than broker-dealer firms, the constitution of the exchange requires the approval of its board of governors for the formation of "member firms" (partnerships) and "member corporations," [52] which are broker-dealer firms in which at least one general partner or director-stockholder is a member of the exchange. A member organization must be engaged primarily in the securities or commodities business as a broker or dealer. No firm may do business with the public unless it has more than two general partners active in the firm's business, and no person is allowed to participate in more than one member firm. As of December 31, 1962, there were 672 member firms, of which about 500 did business with the public. The general partners and voting stockholders of member firms who are not themselves members of the exchange are known as "allied members," and the exchange constitution also requires that they be approved by the board of governors. The exchange therefore determines the qualification standards not only of its 1,366 members, but also of all the firms, corporations, partners, and voting stockholders with whom they are associated.

The exchange first imposed limitations on its membership in 1817, when it restricted the size of the membership and instituted the blackball system to screen applicants.[53] For several decades thereafter, the exchange had many of the aspects of a social organization. Its admissions policy in 1858 has been described as follows:

[The exchange] was in no mood for new members. It had become, in great measure, an exclusive club, a situation of which the brokers were very proud. They wore silk hats and swallowtail coats during business hours. It was a genteel business as well as a profitable one. The entry of young men was frowned upon. To this end, initiation fees were raised to $1,000, a hard fact which kept many young men from joining the organization, even when they were able to overcome the hurdle of five blackballs for membership.[54]

Under the exchange's constitution, to be eligible for either regular or allied membership in the NYSE an individual must be 21 years of

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[51] For a discussion of NASD examination procedures, see ch. XII, below.
[52] NYSE constitution, art. IX, sec. 7(a).
[53] Leffler, "The Stock Market," p. 94 (2d ed., 1957).
[54] Id., at p. 96.

age and a citizen of the United States.[55] He must also be willing to engage actively in the securities business and to devote the "major portion of his time thereto," and to agree to abide by the constitution and rules of the exchange.

To assist the board of governors in passing on prospective members' qualifications with respect to integrity and competence, the exchange has for some time had an elaborate screening and investigation system. More recently it has begun also to pay close attention to the determination of competence through examinations and training programs.

For the prospective regular member, screening starts when he commences negotiations for the purchase of a "seat." A prospective member must make arrangements for the purchase of his seat through the office of the secretary of the exchange, which maintains a file of written bids for and offers of memberships and supervises all final agreements for the transfer of memberships. At preliminary discussions, the staff makes an initial determination whether there is some impediment to the applicant's becoming a member. He is required to fill out an application form giving details on his business history, previous residences, educational background, military service, accounts with banks and brokerage houses, and on any previous involvements in securities violations, other criminal indictments and convictions, financial difficulties and litigation. The applicant must also submit information on his net worth, borrowings, and method of financing the purchase of his seat.

A seat may be purchased by the prospective member for cash, or received by him as a gift, or financed in either of two ways acceptable to the exchange: by a subordinated loan, or by what is termed an "a-b-c agreement." As of March 22, 1963, 502 memberships were subject to a-b-c agreements, which involve the advancement of funds by a firm to one of its partners or officers for the purchase of a seat, subject to certain conditions. A member purchasing his membership under this arrangement agrees that upon terminating his connection with the financing member firm, he will, at the option of the firm, either transfer his seat to a person designated by the firm (and satisfactory to the exchange) for a nominal consideration, or sell it and remit the proceeds to the firm. The individual member has the right to pay his firm an amount sufficient to purchase another membership and thereby keep his seat. Thus, an a-b-c agreement permits a member firm to have beneficial ownership (and thus effective control) of a seat while making it available to the person in whose name the membership is held, enabling him to execute firm orders on the exchange floor.

While an applicant for allied membership is not involved in arrangements for the purchase of a seat, he too is required to submit a detailed application form substantially similar to that required for a regular membership and in most other respects the qualification procedures for the two classes of membership are the same. The exchange recognizes that persons on the floor are by no means the only important ones in a member firm and that office members are equally if not even more important. In fact, a person in whose name a member-

[55] NYSE constitution, art. IX, sec. 2.

ship is held is often not one of the leading partners in a broker-dealer firm. Particularly in a large firm, the partners or shareholders who control the operations of the firm are more likely to be the allied members.[56]

Both regular and allied members must be supported by the sponsorship of two members or allied members. Following the filing of an application, notice of it is posted on the exchange bulletin board and published in the weekly bulletin, while the Secretary's office conducts an investigation to determine the accuracy of the application and whether evidence exists which may reflect unfavorably on the applicant's character. As a part of this investigation, the staff examines the exchange's files to see whether the applicant has been involved in prior disciplinary proceedings, checks to see that financial arrangements and outside business connections conform to exchange policies, writes to the Commission and State securities agencies to request confirmation of a clear record, and, if the applicant was recently a principal of a nonmember firm, conducts an examination of the records, operating policies, and financial position of that firm. Independent professional investigating agencies are also engaged to check the applicant's history and personal and financial reputation, including court and police records.

Staff findings are conveyed to the exchange's subcommittee on admissions, which submits its recommendations concerning admission to the board of governors, which is responsible for the final decision. Applicants must also appear for a personal interview before the subcommittee, or occasionally, in the case of an applicant for allied membership, before a present or former member of the board of governors. When the staff investigation discloses unfavorable information, the applicant is questioned by the exchange staff before he appears before the subcommittee. While the board of governors generally considers applications after notice of them has been posted for 2 weeks, this period may be extended if an investigation is not complete.

Similar screening procedures attend the approval by the exchange of inactive persons engaged in financing member organizations, whether as limited partners, holders of debentures or nonvoting stock, or subordinated lenders. Under exchange rules such persons, known as "nonmembers," must submit applications in substantially the same manner as members and allied members, and are subject to approval by the board of governors as part of its suppervision over various aspects of firms' organizational structures.

The most common reason for refusing an applicant or for suggesting withdrawal of an application is a misstatement on the application. Even where misstatements are minor in nature, the exchange takes the position that they reflect poor character and justify rejection. In one case, a proposed subordinated lender to a large member firm was rejected because he failed to disclose the use on one or more earlier occasions of a somewhat different surname, although there was no implication that the different name had been used for any improper purpose. Other applicants whose files were examied by the Special

[56] Neither Michael W. McCarthy, chairman of the board of Merrill Lynch, Pierce, Fenner & Smith, the country's largest brokerage firm, nor Harold L. Bache, managing partner of Bache & Co., the second largest, is a member of the NYSE.

Study had been rejected because of false statements as to such matters as education, litigation, and outside employment.

The exchange has also disapproved applications and suggested the withdrawal of applications because of prior activities of the applicant. One application for allied membership was denied on the grounds that the applicant had operated an advisory service which the staff described as a tout sheet, and had also associated in various ventures with a notorious Canadian promoter. Another applicant was rejected in his attempt to become an allied member because an examination of his nonmember firm's books disclosed unreasonable price markups and the endorsement and cashing of a customer's check. A background check is also turned up gambling connections of a prospective limited partner of a member firm who was known by the alias of "Benny the Book."

As was noted above in discussing the Martin case,[57] the exchange has devoted extensive attention to screening and investigating the integrity of its prospective regular and allied members, but its approach to assuring their competence has until recently been somewhat more casual. Under the qualifications procedure in effect until this year, a member or allied member [58] proposing to do business with the public but lacking sufficient experience in the securities business was required only to serve as a trainee in the office of a member organization for 6 months, and either to pass the exchange's registered representative examination or successfully to complete certain courses approved by the exchange. Prospective floor members, according to the exchange, were required to work under the guidance of an experienced floor member "for such period as may be necessary to acquaint him with floor procedures."

On October 18, 1962, the board of governors approved new qualification rules which went into effect exactly 3 months later. Members and allied members who intend to work in the office of a member organization are now required to take the office member and allied member examination, testing their knowledge of the following areas: (1) General securities subjects and NYSE rules and procedures; (2) the responsibilities of proprietors in member organizations; and (3) supervision of offices, salesmen, and accounts. Since this examination does not give much coverage to matters related to the sale of securities, such as securities analysis, members or allied members who lack previous experience as salesmen and who want to service customers' accounts are required also to take the registered representatives' examination. Although the revised NYSE rule does not so state, the 6 months' training formerly required of inexperienced office members and allied members continues to be applicable to such persons.

Members planning to engage in activities on the floor are required to take a floor member examination which deals with floor procedures and rules, as well as the office member and allied member examination if they will have supervisory responsibilities. A floor member planning also to service customer's accounts must in addition meet the applicable training and examination requirements. Inexperienced floor members are still required to go through a period of supervised

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[57] See sec. 1.a(3), above.
[58] Nonmembers are not required to meet the exchange's competency requirements.

activity on the floor of the exchange. The examination of floor members is administered after they have completed their initial orientation period, which lasts from 1 to 2 months. Specialists are, at the present time, subject to certain apprenticeship and training rules, requiring an oral examination after 30 to 90 days of training on the floor. There will soon be substituted questions on the operations of the specialist, which will supplement the examination on floor procedure taken by other members. There will also be supplementary questions for odd-lot brokers and dealers.

The exchange's screening, investigating, and testing program appears, from the Special Study's observations, to have operated effectively for the protection of the public. When facts developed by its investigation suggest that a candidate for regular or allied membership (or nonmember status) is unacceptable, the exchange staff generally discourages his continuing his application or recommends his disapproval by the board of governors. In the period from January 1, 1959, through July 26, 1962, 23 applications were withdrawn (not all, of course, because of staff pressure) and 13 were disapproved. A total of 3,370 applications were approved during this period. The program appears to operate with considerable fairness from the point of view of the candidates too, although occasionally a problem of fairness may arise in the withholding from a candidate of information that has been found in the exchange's investigation and that the candidate is powerless to dispute because he is not told of it.

d. Other exchanges

All of the exchanges other than the New York Stock Exchange—the American Stock Exchange and the various regional exchanges—similarly impose requirements on their member firms which relate to the competence and integrity of their principals and the financial capacity of the firms. Dwarfed as these exchanges are in size and resources by the New York Stock Exchange, with a large portion of their memberships also members of the NYSE, they have for the most part been content modestly to follow the lead of that exchange and to rely on it completely for screening partners and stockholders of dual members. In rare instance, however, they have led the way. In any event, the significance of their admissions and qualification standards and of the procedures by which they are implemented relates principally to those firms which are not dual members.

The other exchanges, like the NYSE, are for the most part made up of individual members rather than of the firms with which those individuals are associated,[59] and require exchange approval not only for regular members with access to the floor but also for all partners, stockholders, partnerships, and corporations with which such regular members are associated. Some of the other exchanges, unlike the NYSE, provide for a significantly different category of membership, known as associate membership, the principal privilege of which is the right to have transactions executed on the exchange at a commission rate more favorable than that accorded a nonmember.[60] Such

[59] Some regional exchanges permit ownership of seats by partnerships or corporations. For a discussion of the memberships of regional exchanges, see ch. XII, below.

[60] For a discussion of the significance of associate memberships in relation to the minimum commission rate schedules of the various exchanges, see the discussion of commission rates in ch. VI, below.

memberships are also subject to some form of qualification requirements.

For the most part these exchanges have not formally expressed the standards of qualifications of their members apart from the requirement that they be male citizens of the United States who are over the age of 21.[61] All of them, however, like the NYSE, impose controls over the character and business reputation of their members and of all partners and stockholders of member organizations through the operation of their procedures requiring exchange approval. In general, applications for membership and approval of member organizations and their partners and stockholders are handled much in the manner of the NYSE. The exchanges usually require that applicants for regular membership and new partners and stockholders of member firms file applications containing information on their education, business history, other exchange memberships, previous difficulties, if any, with securities authorities, and the names of references and sponsoring members. A new member usually must furnish similar information on other principals of his firm, a statement of financial condition, and letters of endorsement from persons not members of the exchange.

Except for partners or voting stockholders of NYSE member firms, all exchanges conduct some examination of the information gathered through the application forms. The American and Pacific Coast exchanges use private investigating agencies for this purpose, but other exchanges sometimes rely more heavily on local reputation or the judgment of staff members. In all cases, names of candidates for membership are posted and circulated to the membership.

The admission procedures are presumed by these exchanges to eliminate candidates of doubtful character, but what concern for competence they display is generally on a nominal level, and relates primarily to floor activities of new members. No exchange other than the Midwest and the American Stock Exchanges requires that new members or principals of member firms do any more to show their awareness of their responsibilities as broker-dealers or of the record-keeping and other back-office duties required of them than serve a brief apprenticeship, and often this apprenticeship may be served after the applicant has become a member rather than before. New floor members of the American Exchange are required to work in the company of an experienced floor member until the floor governors release him, usually not before he has traded under supervision for at least a month. For new members desiring to do business with the public, the American Exchange requires 6 months' experience in the securities business. That exchange is, however, considering the requirement that all prospective members pass a written examination similar to that required by the New York Exchange.

Most other exchanges impose no additional check on competency except, for persons lacking prior securities experience, the successful completion of requirements for registered representatives and supervised initial dealing on the floor of the exchange. At the Midwest Stock Exchange for some years, new "Midwest only" members or new

[61] The Midwest, Detroit, and Pacific Coast stock exchanges also permit Canadian citizens to be members.

partners of old Midwest-only firms who, in the judgment of the exchange, did not have sufficient experience, have been required to undertake further training and pass an examination. To become a floor broker, that exchange for about 10 years has required completion of a 6-month training period on the floor, and since June 1960 has also required that an applicant pass a 25-question written examination administered by a staff of the exchange before purchasing a membership. Its floor-broker examination appears to have been the first such competence requirement instituted by an exchange.

e. The State controls

Three States and the District of Columbia impose no restrictions upon entry into the securities business as a broker-dealer within their territorial limits.[62] Those States which do impose restrictions vary greatly in the strictness of the controls which their statutes establish and in the vigor with which they are administered. While all of these States require registration of broker-dealers, in New York State, where a substantial portion of the Nation's securities business is transacted, registration involves no more than disclosure of certain pertinent facts on such matters as the backgrounds of principals and salesmen and keeping such information up to date.[63] Indeed, in New York there is no authority to deny, revoke, or suspend registration on any standards, and the information required to be filed is limited, so that the registration provision is little more than an adjunct to the criminal fraud provisions. Even where State statutes authorize the imposition of barriers to entry, limitations of budget, and manpower often handicap State administrators.

Since 1934 the Federal securities laws have recognized that transactions in securities, whether on exchanges or over the counter, are affected with a national public interest making necessary their Federal regulation and control,[64] and in the area of controls over entry as in other areas, the instrumentalities of the separate States have been clearly inadequate to cope with what is essentially a national problem. To say this is not to say that State controls over entry, where they exist, do not perform a valuable function. On the contrary, interviews with a number of State administrators by the study staff have made clear that State standards with respect to integrity and experience of principals of broker-dealer firms and with respect to the firms' financial capacity all serve a useful purpose. Not the least of their benefits is a reduction of the burdens of enforcement regarding those who meet the standards imposed. Nevertheless, from a national point of view, in the absence of uniform State legislation and standards of enforcement, the most that can be expected from even the best of the State laws and administrations is to point the directions in which a system of national controls can profitably move.

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[62] Delaware, Nevada, and the District of Columbia have no blue-sky laws at all. Wyoming places almost no restrictions upon broker-dealers, requiring only that "promoters" offering securities for sale "either as principal or through brokers or agents" file the names and addresses of their agents, partners, directors, trustees, or major shareholders. Wyo. Stat., sec. 17-103 (7), (8) (1957).

A securities act for the District of Columbia, based on pts. I, II, and IV of the Uniform Securities Act, has been proposed to the Congress by the District Commissioners.

[63] See, generally, N.Y. Gen. Bus. Law, art. 23A, sec. 359(e).

[64] Exchange Act, sec. 2.

The Uniform Securities Act, which has been adopted in substantially identical form by 15 States [65] and is expected to become law in several other States, is widely accepted as setting standards for admission that are as high as those of any States and are the pattern for the best in State law today. Under the uniform act it is unlawful for a firm to transact business within the State concerned, as a broker-dealer or agent,[66] unless registered under the act. Registration of a broker-dealer firm automatically registers as agents those of its partners, officers, or directors who perform salesmen's functions; other salesmen must be registered separately by the firm. The application form may, in the discretion of the State administrator, require information on "such matters as" the manner in which the applicant plans to do business, the qualifications and business history of all proprietors, partners, officers, and directors of the firm, and of "any person occupying a similar status or performing similar functions * * *" and, for such persons, the record of injunctions, administrative orders, or felony or misdemeanor convictions involving securities, and other felonies. Information on the applicant firm's financial condition and history is also required.

Registration may be denied not only on the basis of the data contained in the application but also on the basis of any other information gathered by the State administrator. The grounds on which registration may be denied go further than those constituting bars under Federal law, and disqualify as well persons with convictions within the past 10 years of felonies not related to the securities business, persons expelled from the NASD or a national securities exchange within the past 5 years through action by the SEC and persons subject to postal fraud orders. In addition, the Uniform Act gives the administrator two potent weapons with which to deny applications by authorizing the exclusion of persons who (*a*) have "engaged in dishonest or unethical practices in the securities business," and who (*b*) are "not qualified on the basis of such factors as training, experience, and knowledge of the securities business. * * *" [67] In order to determine qualifications under this last provision, the act gives the administrator the power to "provide for an examination, which may be written or oral or both, to be taken by any class of or all applicants. * * *" [68]

Although bad character and business repute are not among the stated background facts which may disqualify a person under the Uniform Act, the provision barring applicants who have "engaged in dishonest or unethical practices in the securities business" may have a similar effect insofar as persons previously in the securities business are concerned. Its general language, however, occasions some criticism. The securities administrator from Washington State commented:

> * * * I have had a little problem trying to figure out exactly what that covers. That could cover a multitude of most anything.

[65] Alabama, Alaska, Arkansas, Colorado, Hawaii, Indiana, Kansas, Kentucky, Maryland, Montana, New Jersey, Oklahoma, South Carolina, Virginia, and Washington, as well as in the territory of Guam.

[66] The Uniform Act uses the term "agent" to describe the same person referred to in the report as a "salesman." State regulations pertaining to the admission of salesmen to the securities business, including provisions analagous to those touched upon here in reference to broker-dealers, are discussed in pt. C.3.e, below.

[67] Sec. 204(a)(2) (G) and (I).

[68] Sec. 204(b)(6).

Ohio's securities law, which is in most respects substantially similar to the Uniform Act, provides that failure of a broker-dealer to meet standards of good business repute is one of the grounds upon which a dealer's license may be refused.[69]

Although the Uniform Act authorizes the State administrators to provide an examination, actual examinations for registration as broker-dealers are required in only a minority of States. The trend seems to be in the direction of more State examinations. One of the States requiring an examination is Kansas, which tests new broker-dealers and agents who have not passed the New York, American, Midwest, or Pacific Coast Stock Exchange examinations.[70] The Ohio administrator, although not using an examination to test prospective broker-dealers' competence, on occasion rejects applications from persons with little securities experience and suggests that they seek employment with another firm before going into business on their own.

3. PROBLEMS OF FINANCIAL RESPONSIBILITY OF BROKER-DEALERS

Entry qualifications for broker-dealers typically include requirements aimed at assuring their financial responsibility and stability. The Commission's requirements include Exchange Act rule 15c3-1 which limits the ratio of broker-dealers' "aggregate indebtedness" to "net capital." [71] The laws of many States and the rules of the major exchanges go beyond such net capital ratio rules and impose minimum capital and/or bonding requirements in various amounts and of various types, but these do not cover the majority of broker-dealers.[72]

While net capital ratio rules are desirable and necessary, the stated views of numerous responsible persons in the securities business, the existing minimum capital and bonding requirements imposed by various exchanges and States within their own spheres, and the experience of the Commission all point to the conclusion that these ratio rules alone are not sufficient. A vital element in the generally higher standards of qualification for broker-dealers recommended by the study would be a minimum net capital rule applicable to all registered broker-dealers.

There are numerous reasons. First of all, the securities laws, Federal and State, and the general law of fraud rely heavily on the sanction of civil liability in favor of those who may be injured by violations of broker-dealers. In underwritings particularly, broker-dealers are subject to liability under the Securities Act for rescission and damages with respect to securities sold under a false or misleading

[69] Ohio Revised Code, secs. 1707.15 and 1707.19. The Texas blue-sky law is more explicit, referring to "the good repute in business of the applicant, his directors, officers, copartners, or principals," and conditioning registration upon the administrator's not finding "any inequitable practice in the sale of securities or * * * any fraudulent business practice" by the "dealer, agent, salesman, or any officer, director, partner, member, trustee, or manager of such dealer." Texas Rev. Stat., art 581-13, 581-14 (Vernon, Supp. 1962).

[70] Kans. Gen. Stat., sec. 17-1254(b) (Supp. 1959), and rule 81-8-1, 1 Blue-Sky L. Rept., par. No. 19613 (1962).

[71] Further discussion of the net capital ratio requirements of the Commission and certain exchanges, which apply at the point of entry and thereafter as "operational" requirements, appears in ch. III.D.3.d. Among the points considered there are the meanings of "aggregate indebtedness" and "net capital." It should be briefly noted here that "net capital" is the net worth of a firm adjusted to take into account, among other things, the value of securities inventory reduced by certain arbitrary percentages (colloquially known as "haircut" provisions) depending upon the type of security. These adjustments, in practice, ordinarily result in "net capital" being less than 'net worth."

The discussion in this section focuses upon minimum net capital rules.

[72] The NASD has no rules relating to the capital of its member firms; it does, however, enforce the Commission's net capital ratio rule. See ch. XII.

registration statement, or for failure to use a prospectus or for certain communications which contain untrue facts or omit to state material facts, and these contingent liabilities continue for a period of up to 3 years from the date of offer or sale.[73] This point is not confined to underwritings and underwriters; in marginal situations generally, whether of underwriters or general broker-dealers, the difference between having money at stake and being completely judgmentproof can obviously affect the seriousness with which established legal duties are viewed in practice.

Secondly, no firm should commence operations on so thin a margin that it is wholly dependent on day-to-day business to keep its doors open or to maintain with a reasonable degree of continuity the number and kind of personnel, including competent back-office help, that the nature and size of its business may require. In particular, no firm handling or having custody of customers' funds and securities should have such a small amount of its own resources that customers' assets may in fact become the principal working capital of the firm.

Third, the smooth and speedy handling of securities transactions within the financial community itself requires that all members of that community have at least such minimum equipment of personnel and resources that they may reasonably rely upon one another's ability to do business responsibly. One aspect of this concern was expressed by a member of the New York Stock Exchange who noted in 1913 that the sponsors of a prospective exchange member were asked if in the ordinary course of business they would accept his check for $20,000.[74] Undoubtedly the same kind of concern is manifested in the fact that the National Quotation Bureau, Inc., publisher of the interdealer quotation "sheets" for over-the-counter markets,[75] although having no regulatory authority or responsibility but acting merely in the name of good business, has long imposed net worth requirements on broker-dealers entering quotations in the sheets. As amended in 1962, these requirements call for a showing of a net worth of $50,000 for a corporation and $10,000 for an individual.

Finally, an even broader and more fundamental consideration underlying all of the above is that those entering the securities business as entrepreneurs should have such sense of commitment to their business as is likely to produce responsible, reliable operations. Standing alone, a requirement for minimum net capital obviously does not assure this, but taken together with other entrance qualifications it adds a layer of protection and contributes to a degree of total assurance that a new firm will enter the securities business with that serious sense of commitment and obligation that the special quality of the business demands of all entrepreneurs.

An acute example of the headaches, both for customers and for the regulatory authorities, which can arise out of the operations of the undercapitalized broker-dealer is the case of E. H. Jansen Co. of Miami Beach, Fla. The firm was organized by three young men in December 1958, as American Mutual Funds Service, Inc., with a total adjusted net capital of $42. A Commission examiner, visiting the firm shortly after it had begun to do business, noted in his report that

[73] Securities Act, secs. 11, 12, and 13.
[74] Van Antwerp, "The Stock Exchange From Within," pp. 272–273 (1913).
[75] See ch. VII.

"registrant's officers are young, inexperienced individuals with some illusions of grandeur."

Within a year of its registration, the firm became inactive, although it did not terminate its registration with the Commission, and the three officers took other jobs. Two of them, when located by the Commission, were engaged in the drapery and slipcover business on a full-time basis. The firm's books and records had not been kept up since before the temporary abandonment of the firm by its partners.

In September 1961, one of the officers was approached by an individual who wished to dispose of $75,000 worth of stock for a customer, and the officer agreed to an arrangement whereby the firm would resume business under a slightly different name and would sell the stock to the public. Shortly after this resumption of its business, the firm began to run into net capital difficulties. Because of these financial problems its stockholders sold the firm to Edward H. Jansen, who changed the name of the firm to E. H. Jansen Co. No notice was given to the Commission of the changes in name and ownership, although failure to notify the Commission of such changes is in violation of its rules.[76]

By December 1961, the firm's financial condition had deteriorated to the point where it could not pay for securities purchased. Attempts by Commission investigators to ascertain the firm's financial condition were thwarted by incomplete and incorrect records. The Commission thereafter ordered hearings to determine whether the broker-dealer registration of the chameleonlike firm should be revoked and whether four of the persons involved with its operations should be named as causes of the Commission's action.[77]

The manner in which this firm was organized and the indifference of the persons connected with it to the responsibilities involved in doing business as broker-dealers evidence a lack of commitment to the securities business which is a danger to the investing public. A customer of a firm of this type may find its doors open one day and shut the next, its principals devoting their full time to a drapery and slipcover business. Furthermore, the likelihood of the principals' being adequately trained to conduct the business of a broker-dealer is small. In addition to the danger to investors, an extra burden is placed upon the regulatory bodies in their exercise of surveillance over marginal firms of this type.

The drapery and slipcover feature may be unique to this one instance, but the thinness of capital is not. Among 215 new broker-dealer registrants in a typical 6-month period in 1956,[78] initial reported "net capital"[79] was less than $1,000 in the case of approximately 27 percent; between $1,000 and $2,500 with respect to 16 percent; and between $2,500 and $5,000 with respect to another 17 percent.

a. The present pattern of requirements

(1) *The Federal controls*

The Commission's regulation of the financial responsibility of firms registered with it is accomplished through its net capital ratio rule,

[76] Exchange Act, rule 15b-2(b).

[77] Exchange Act release No. 6774 (Apr. 9, 1962).

[78] See table II-4. This period was arbitrarily picked by the study to allow an interval of several years since original registration, for purposes of other data set forth in the table, as discussed below. With respect to initial reported net capital, it is believed that the data for more recent periods would be generally similar.

[79] See ch. III.D.3.d.

which is applicable to most registered broker-dealers. Under section 15(c)(3) of the Exchange Act, the Commission is authorized to prescribe such rules—

> as [may be] necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers.

Although the Commission has stated that under this provision it has the authority to adopt a rule conditioning registration of broker-dealer firms upon their having a reasonable minimum amount of capital committed to the business they intend to carry on,[80] it has not imposed such a requirement, nor has it adopted rules relating to fidelity or surety bonds for broker-dealer firms. The net capital ratio rule is not so much a qualification device as it is a continuous, "operational" requirement which a broker-dealer must meet throughout the course of business. The rule requires that "aggregate indebtedness" be not more than 20 times "net capital," as these terms are defined.[81] So long as a firm maintains low aggregate indebtedness, it may operate on limited net capital. Each $1,000 increment of aggregate indebtedness, for example, requires an increase of only $50 in net capital to satisfy the rule. The rule thus is of limited effectiveness in assuring significant ability to meet common law or statutory liabilities or in meeting several of the other concerns mentioned above, and it does little to assure that a broker-dealer has any commitment to the business. To say these things is not to question the utility of the rule but solely to indicate that it does not of itself give any real assurance of financial responsibility as a basic ingredient of broker-dealer qualifications.

The limits of a ratio rule are particularly evident in the area of underwriting. A firm commitment underwriting of common stock requires a broker-dealer to have excess net capital [82] equal to 30 percent of the amount of his commitment. A "best efforts" underwriting, however, does not in itself bring the rule into play at all; it is no accident that, even during the recent period of "hot" issues, when the risk of inability to sell was minimal, a substantial number of issues handled by marginal underwriters were on a "best efforts" basis.[83] This device permitted many firms to undertake the special responsibilities of underwriting but to treat the otherwise potent liability provisions of the Securities Act as truly a paper tiger.[84]

(2) *The NASD*

Although the association requires the submission of financial data with an application for membership, it does not have any minimum capital or bonding requirements on which it could base a refusal to grant membership. The association in 1942 proposed an amendment to its bylaws to require a minimum net capital of $5,000 for members dealing directly with the securities and funds of the public, and $2,500 for those who settled contracts through a bank or another member without receiving securities or funds of any customer. The

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[80] *In the Matter of the National Association of Securities Dealers, Inc.*, 12 S.E.C. 322 (1942).
[81] See ch. III.D.3.d.
[82] Ibid.
[83] Of 568 issues of unseasoned common stock in 1961, 355 were offered on "best efforts" basis. See ch. IV, table IV-26.
[84] See further discussion in ch. IV.B.

Commission disapproved the proposal on the grounds that a requirement for minimum net capital did not constitute an appropriate basis for determination of membership under section 15A(b)(3) of the Exchange Act.[85] The association has not since proposed capital or bonding qualifications for membership, although, as indicated below, its current leadership is no less convinced of the need than its leadership in 1942.

As already mentioned, the wide breach resulting from the absence of an NASD minimum capital requirement for its members has been but partly filled through the action of the unofficial National Quotation Bureau in requiring a showing of substantial net worth by the more limited group of broker-dealers who enter quotations in its sheets.

(3) *The New York Stock Exchange*

The exchange, in addition to having a net capital ratio rule,[86] has a minimum net capital maintenance requirement. Both rules apply with particular force to broker-dealers having transactions with members of the public and holding customers' funds or securities. Thus, rule 325 of the exchange requires member firms carrying accounts for customers to maintain a net capital of at least $50,000; those firms doing business with other members or member organizations, or doing general business with the public but not carrying customers' accounts, must maintain a net capital of at least $25,000.

Floor brokers, traders, and specialists having no public business are not covered by rule 325. The latter, however, generally must be able to assume a position of 400 shares of each stock for which they are registered specialists in which the "unit of trading" is 100 shares and positions of 100 shares of each 10-share-unit stock.

The exchange, in addition, requires under rule 319 that all member firms doing business with the public and all member corporations carry "fidelity" bonds covering its general partners (or officers) and employees. These bonds are the brokers blanket bond and the stockbrokers partnership bond. Their size varies directly with the firm's net capital: the higher the net capital the greater the amount of bond. The bonds serve only indirectly as a protection to the public investor because customers cannot bring an action personally for losses covered by them (as is true of some though not all surety bonds).[87]

The brokers blanket bond essentially covers losses resulting from dishonest or careless acts (theft, embezzlement, loss or misplacement of property, etc.) but not from violations of Federal and State securities laws or from insolvency. The partnership bond, developed after the situation involving Du Pont, Homsey & Co., where losses totaling more than $700,000 were caused by the defalcation of the senior partner, indemnifies a partnership against the loss of property, including money and securities, resulting from a "fraudulent or dishonest act or acts" committed by any general partner, but excludes losses—

> * * * directly or indirectly, caused by or resulting from any misrepresentation as to the value of securities made by one or more of the insured general partners covered under this bond or in which such partners are concerned or implicated.

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[85] 12 S.E.C. 322.

[86] The SEC, deeming the New York Stock Exchange's net capital rule more comprehensive than its own, exempts members from the Commission's rule. Exchange Act rule 15c3-1(b)(2).

[87] Surety bonds are briefly described at note 93, below.

Apart from the mandatory requirements of rule 319 for member organizations, the New York Stock Exchange has procured a blanket bond in the amount of $10 million, covering all members of the exchange to the extent that fidelity losses exceed the amount of coverage of the firm's own bond.[88]

(4) *The other exchanges*

The American and major regional exchanges have also shown commendable concern for member firms' financial responsibility. The Commission has exempted from its own net capital ratio rule any members of the American, Boston, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh Stock Exchanges, all of whose rules are deemed, like the New York Stock Exchange's, to impose requirements more comprehensive than the Commission's.[89]

An important respect in which those requirements are more comprehensive is that, in addition to imposing indebtedness-to-capital ratios,[90] all the foregoing exchanges have minimum capital maintenance requirements, applicable to most member organizations. All clearing members of the American Stock Exchange and all other members having public customers must have a net capital of $50,000. Other members must have net capital of $25,000. The Boston Stock Exchange requires sole proprietorships and partnerships not carrying margin accounts to maintain minimum capital of $10,000, and all other sole proprietorships, partnerships, and corporations to maintain minimum net capital of $25,000. The Midwest Stock Exchange requires member firms or corporations which clear or do business with the public to maintain a "liquid net capital" of at least $25,000; individual applicants for membership must have liquid net capital of at least $10,000 over and above the cost of membership. The Pacific Coast Stock Exchange, though permitting temporary exceptions, requires that members and member firms doing business with the public "shall maintain minimum net capital in an amount at least $5,000 in excess of 5 percent of his or its aggregate indebtedness, or not less than $25,000, which ever is greater." Comparable though not identical requirements are in force on the Philadelphia-Baltimore-Washington, Cincinatti, Pittsburgh, and Salt Lake Stock Exchanges.

It should be noted that, as in the case of the New York Stock Exchange, the minimum capital requirements of these exchanges are in addition to and not a substitute for a bond. The American, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, and Pittsburgh Stock Exchanges require members to have employees blanket bonds and partnerships bonds. The size of the required bonds increases in relation to the amount of net capital.

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[88] Officials of the NASD have pointed out to the study that it would be impossible to consider any form of group responsibility and protection for customers of individual members so long as the gates of entry are so wide open that financial responsibility of the individual member cannot be assumed.

[89] Exchange Act, rule 15c3–1(b)(2).

[90] The net capital ratio rules of the Midwest and Pittsburgh Stock Exchanges are stricter than those of the Commission and the New York Stock Exchange in that they impose a maximum permissible ratio of aggregate indebtedness to net capital of 15 to 1 rather than 20 to 1. The New York Stock Exchange imposed a 15-to-1 ratio at one time but relaxed it in 1953.

(5) *The States*

The 33 States [91] imposing capital and/or bonding requirements for broker-dealers follow varying patterns. Some require a minimum net worth or net capital as a condition to registration. One such State is New Hampshire, which requires that broker-dealers have a net worth of not less than $25,000.[92] Other States required a surety bond [93] regardless of a firm's capital; Iowa, for example, has no minimum capital rule but requires a surety bond of $5,000.[94] A third group uses a "combination" principle (which is also recommended in the Uniform Securities Act)[95] requiring a surety bond but only in the event that a firm's capital, as defined in the statute or by appropriate regulation, is less than a given amount. Section 202(e) of the Uniform Securities Act authorizes the administrator to require broker-dealers, agents, and investment advisers to post surety bonds in amounts up to $10,000, but no bond may be required for any registrant whose net capital, as defined, is more than $25,000. New Jersey's requirements are more elaborate than those of most jurisdictions and exemplify this third approach, taking into account the varying degrees of risk attached to various functions which broker-dealers perform.[96] Another variant of the "combination" principle conditions the size of the required surety bond on the number of agents employed by the broker-dealer.[97]

Most States requiring surety bonds permit an "appropriate deposit" of cash or securities as an alternative. A State statute that did not contain such an alternative was once declared unconstitutional on the ground that the statute constituted a deprivation of liberty without due process of law under the 14th amendment.[98] Surety bonds are not always readily available. When available, on the other hand, surety bonds cost only $15 to $25 per thousand dollars of coverage per year, and thus represent no assurance that a broker-dealer has any commitment to the business, nor that it has sufficient capital to meet the various needs noted at the outset.

b. The need for a generally applicable minimum capital requirement

In 1942, at the Commission's hearing on the NASD proposal of a minimum capital requirement as a condition for the NASD membership, the association's chairman said:

> * * * [T]he Board found that too often meager capital or no capital at all and the abuse of public trust and the rules of the association were inclined to go

[91] Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Utah, Vermont, and Virginia. Additionally, Montana requires that each salesman be covered by a surety bond for $5,000. Montana Rev. Code, title 15, sec. 2006(2). Illinois and Wisconsin impose a net capital ratio rule like that of the SEC on any broker-dealer not subject to the Commission's rule or that of an exchange. Illinois: Regulations, Secretary of State, rule D, rule 1; Wisconsin: Regulations, Department of Securities, sec. 1.01.

[92] N.H. State Insurance Commission Reg. No. 2.

[93] A surety bond typically permits an aggrieved person to sue directly on the bond for violations, by the bonded broker-dealer or his agents, of the applicable blue-sky law. The range of coverage is broader than that of brokers blanket bonds and partnership bonds, which do not cover violations of Federal or State securities laws and under which there is no direct right of action by a member of the public. See, e.g., Uniform Securities Act, sec. 202(e).

[94] Iowa Code, ch. 502, sec. 18.

[95] Uniform Securities Act, sec. 202 (d), (e).

[96] N.J. Rev. Stat. sec. 49:3–10; Regulations, N.J. Bureau of Securities, pt. I, rules 2 and 3; pt. II, rules 2 and 3.

[97] See, e.g., New Mexico Statutes, 1953, secs. 48–18–20.2 and 20.3; Regulations, Commissioner Securities, No. 59–101.

[98] *Riley* v. *Sweat,* 111 Fla. 362, 149 So. 48 (1933).

together. I believe it is obvious that an organization whose capital has been vanishing or an organization that is in the red would find it difficult to avoid the temptation of taking inordinate profits on transactions with customers since such profits would help to restore a balance on the financial statement. We would like to dissipate some of the temptation. We don't say that these capital requirements will do away with all abuses, but we do believe that they will be helpful.

Our examination and enforcement program, during the course of which we reviewed financial and business practices of over 2,200 members, convincingly showed that in those areas where capital was a requisite to securing the State license, violations of association rules were proportionately less and much easier surveillance was possible. We had this experience, for example: Two States adjoin each other, in one of which there is a statutory capital requirement and in the other there is none. Our examinations of members in the latter resulted in complaints having to be filed against one-third of the membership in the State; whereas in the State having a capital requirement statute, only one case of insolvency presented itself and in relation to total number of members involved in this instance, the ratio was infinitesimal. Our experience in other States where capital requirements are included in the statute or enforced by administrative action was gratifyingly comparable * * * [99]

It is apparent that the association's experience in the intervening period has not changed its position. The NASD submitted to the study a memorandum which placed at the head of a list of additional powers needed by the NASD to fulfill its regulatory responsibilities the power to impose an "initial capital before becoming members * * *." It was further suggested that there might be separate requirements for those selling mutual funds and that there might be bonding, in addition to capital, requirements. Avery Rockefeller, Jr., the 1962 chairman of the board of governors of the NASD, testified during the study's public hearings that the board "strongly favors" a minimum capital requirement. And Wallace H. Fulton, executive director of the NASD, has stated on numerous occasions his support of a minimum capital requirement.

A number of other members and representatives of the securities industry have recommended to the Special Study that a Federal minimum capital requirement be created to complement the Commission's present net capital ratio rule. Active and responsible members of the industry have almost invariably given prime emphasis to a minimum capital requirement in expressing their views as to needed improvements in existing rules. James E. Day, president of the Midwest Stock Exchange, expressed his views as follows:

I think you need to have a line drawn so that there are some definite financial requirements rather than to be more or less wide open as is the case today * * *. I think you have to measure [additional restrictions] in relation to the good of the whole or on balance.

By their actions even more than any mere expressions, the Midwest and other exchanges have, of course, made clear their views as to the significance of capital requirements.

The principal objection to a minimum net capital rule—in a sense the other side of the point that a minimum net capital rule cannot by itself assure financial or other responsibility—is that worthy individuals without capital may be excluded from the business. The exclusion, at most, would not be from the securities business, but from the right to set up a separate broker-dealer entity without a modicum of capital. It is true that most of the learned professions do not require

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[99] Transcript, pp. 32–33, *In the Matter of National Association of Securities Dealers, Inc.* (Aug. 13, 1942).

a newcomer to have capital, but they do require serious commitment in the form of extended education. Most merchandising businesses do require a starting fund of capital commensurate with the kind and size of business undertaken, at least if there is to be any assurance of continuity and success. The securities business is intermediate, involving more intricate merchandise and higher levels of obligation than the ordinary business. The question is whether a modest capital requirement is an appropriate element in the recommended general tightening of standards for entry into the securities business—in the words just quoted—"in relation to the good of the whole or on balance."

Information available to the study from Commission records indicates that a disproportionate number of violations of Commission rules occurs among broker-dealers with limited capital, and thus gives objective support to the views expressed above. An analysis was made of the first financial reports [100] filed with the Commission by 215 broker-dealers whose applications for registration were filed between July 1 and December 31, 1956. On August 1, 1962, 95 were still in business, the registrations of 26 had been revoked by Commission action, and the registrations of 94 had been withdrawn voluntarily. In table II–4, broker-dealers in the sample are classified by net capital and ratio of aggregate indebtedness to net capital as of the date of their first financial reports to the Commission. It can be seen that half of the revocations are concentrated among the 58 firms (or 27 percent) in the sample which reported net capital of less than $1,000 at the time of their first reports. The 130 firms (or 60 percent) in the sample having net capital of less than $5,000 accounted for 73 percent of the revocations. It may be, of course, that low capital was not the cause of these violations, and that lack of experience or aptitude for business played a part. Nonetheless, the fact remains that firms with low capital were involved in a high proportion of revocation actions by the Commission.

The figures available to the study tend to indicate also that firms with net capital smaller than $5,000 may have a significantly higher chance of falling into net capital difficulties under the Commission's ratio rule than those with a greater amount. In table II–5, registered broker-dealers, other than New York and American Stock Exchange members, are classified by net capital and by ratio of aggregate indebtedness to net capital, according to the latest financial reports submitted to the Commission as of December 31, 1961. The table indicates that 210 out of 220 broker-dealers whose reports indicated violations of the Commission's capital ratio rule had net capital of less than $5,000. These 210 represented 11.5 percent of the 1,804 broker-dealers having net capital of less than $5,000, and 4.1 percent of the 5,123 broker-dealers whose reports were analyzed. The 10 broker-dealers with net capital of more than $5,000 who were in violation of the capital ratio rule, in contrast, represented only 0.3 percent of all firms with more than $5,000 and 0.1 percent of the total of 5,123 broker-dealers.

A study of the latest financial report of each of the 503 broker-dealers engaged in underwriting "unseasoned" issues in 1961 [101]

[100] These reports, under Commission rules, must be filed not less than 1 nor more than 5 months after a firm has become registered; all firms in the sample became registered within 30 days following their applications.
[101] This study is described in detail in ch. IV.B.

showed that 104 had a net capital of less than $10,000; the reports of 34 indicated net capital of less than $1,000, including 21 with net capital deficits. Underwriters with capital of $1,000 or less, or even $10,000,[102] hardly can be said to have such commitment to the business of such financial stake as to engender a sense of the especially high responsibilities entailed in underwriting, or to make the statutory provisions for civil liability an effective deterrent to fraudulent or responsible activities.

A number of persons have suggested that a Federal fidelity or surety bond requirement be imposed in addition to or in lieu of a capital requirement. It would seem, however, that such a requirement would present a number of practical difficulties and that more significant protection to the public can be assured through a Federal net capital requirement. No recommendation as to bonding, therefore, will be made at this time.

c. The variety of needs

While it is believed that all entepreneurs in the securities business should be subject to some kind of capital requirements, the amount required to provide minimum operating resources and minimum protection for the public may vary considerably for differing types of broker-dealers.

At one end of the scale is the small mutual fund distributor with no employees and minimal fixed expenses. Ordinarily he does not handle the securities he sells, maintain an inventory of securities, or receive customers' funds except in the form of a check payable to the fund or its custodian bank. Occasionally, however, he may be paid in cash or may receive other securities to be sold in order to purchase mutual fund shares, and thus come into possession of a customer's funds or securities for a short period of time.

The broker-dealer selling a larger variety of securities will have greater need for operating capital, even though his volume of business may not be larger. He may regularly handle customers' funds and securities. He may also receive, and be required to pay for, securities for which he has not yet received payment from his customer.[103] Often he holds securities in custody for his customers; the recordkeeping and custodial expenses may be considerable and he is accountable for these securities.

The larger firm will have larger needs; these may, of course, range over a considerable gamut. One obvious measure is the size of a firm's selling organization and another is the number of its separate offices with their separate demands of overhead. The practices of a few States [104] take account of at least the former criterion. Both would seem to be appropriate, workable guides in establishing minimum capital requirements adjusted for differing needs.

Other variations may exist in terms of the type of business conducted, apart from size. This is already suggested above with reference to underwriting firms, and similar considerations may apply,

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[102] An underwriter with net capital which is $10,000 more than that required to support his aggregate indebtedness can "take down" not more than about $33,000 of a firm commitment underwriting of common stock. (See ch. III.D.3.d.) In the event that the underwriting is on a "best efforts" basis, however, there is no limit as to the amount which he may undertake to sell with even less capital.

[103] This is not necessarily a violation of the Federal regulations governing extension of credit. See ch. X.

[104] E.g., New Mexico. See note 92 above.