To: The Commission

From: Sherlock Davis, Assistant Director,
Trading and Exchange Division

Subject: Over-the-Counter Problems and the Maloney Bill

I wish to draw the attention of the Commission to certain problems concerning the over-the-counter markets which have been the subject of recent discussion in the Trading Division. At this point I shall do no more than outline in very general fashion certain of the more crucial questions which merit consideration and treatment most immediately. In similarly undetailed manner I have indicated some broad lines of approach to the problems posed which the Commission may take under Section 2 of the Maloney bill, without attempting to refine those suggestions to the "rule" stage.

The Commission does not possess detailed information as to the nature and extent of trade practices on the over-the-counter markets and their variations in different sections of the country. Therefore, before the Commission reaches the rule-making point, it would seem desirable to obtain the industry's reactions and suggestions on the points involved. In that connection I suggest the industry be canvassed thoroughly for a written expression of its views, and thereafter that a conference be arranged between representatives of the trade and the Commission to work out differences in policies and details.

1. Free Credit Balances

(a) Problem:

There is little need to elaborate upon the practice indulged in by many brokers and dealers, respectable as well as unscrupulous ones, of employing customers' free credit balances for their own uses. Frequently brokers and dealers who are pressed for cash finance their own obligations and commitments with their customers' free funds. Sometimes the free money of one customer is used to bolster up the account of another customer. In many instances this diversion of customers' money is effected without the knowledge or consent of the client in question, who, ordinarily, is under the impression that his money is segregated for him and is obtainable at any time upon request.

The lack of any restrictions on over-the-counter brokers and dealers in the use of customers' free funds has encouraged a policy of borrowing from Peter to pay Paul. Weak or insolvent firms have been enable to remain in business because of financial support obtained from clients' free money. The Commission's records reveal at least one instance in which a broker-dealer was insolvent over a period of three years but remained in business with the aid of his customers' free credit balances. (See Engle and Engle).

In addition, the failure to place hedges around the broker-dealer's use of his customers' free funds operates to stimulate the broker-dealer's speculative activities, and to encourage him to assume commitments not warranted by his own capital resources.

(b) Remedy:

As an effective method of curtailing the improper and undesirable practices outlined above, it is recommended that brokers and dealers be required to abandon what is essentially a banking function, i.e. acting as a depository for their customers' free cash. Affirmatively a broker-dealer should be required to place his customers' free credit balances in the hands of an independent escrow agent, which, in most instances, will be a bank.

At all times the broker-dealer should keep on deposit with the escrow agent a cash amount equal to the total credit balances of his customers at the end of each day. Of course the amount of total credit balances may vary from day to day as the result of shifts in customers' positions. Such changes should be reflected daily in the account held with the escrow agent, so that at no time will customers' free credit balances exceed the amount of money held by the escrow agent. The protection thus afforded the customer in the event of the broker-dealer's insolvency is patent.

In case of the broker-dealer's insolvency, it is essential that the escrow agent possess no claim against the broker-dealer which might be asserted as a lien against the broker-dealer's deposit with the agent, in priority to the claim of the broker-dealer's customers. The difficulties involved in a situation where the escrow agent and the broker-dealer's customers have conflicting claims may be obviated by requiring the broker-dealer to open the "credit balance account" in a bank with which he transacts no other business, or to which he owes no debts. Alternatively, the practice now pursued by many reputable concerns might be made obligatory, viz. the execution of a contract between the broker-dealer and the bank stating that funds in the "credit balance account" are funds of the customers and are available only for their claims.

As an additional safeguard, it seems desirable that brokers and dealers be required to supply their customers with periodic statements of their accounts, which would include information as to the amount of the customers' free credit balance. If the particular broker-dealer were a member of a "Maloney association" that information should be made available to the association. See #________, infra p. ______.

Requiring brokers and dealers to escrow customers' free credit balances does not impose any undue burden on the industry. A broker-dealer need maintain only one general account for all his customers' free funds, rather than an individual account for each customer.

2. Free Securities

(a) Problem:

The questions relating to the unrestricted use by a broker-dealer of his customers' free securities are in many respects similar to those concerning free credit balances. Thus, a broker-dealer with ready access to customers' free securities may use them to cover his own short positions or other commitments, or cover up the accounts of other customers. Because of the similarity of abuses attendant upon the unrestricted use of free credit balances and free securities, it is suggested that the escrow device, described above in connection with credit balances, be applied with some differences to the problem of free securities.

(b)

Remedy:

Unlike free credit balances, free securities need not be escrowed as soon as they come into the possession of the broker-dealer. Customers may desire to take delivery within a few days, or wish to trade in and out of a stock within short periods of time.

To insure the flexibility necessary for such situations, it is suggested that a broker-dealer be permitted to retain free securities in his possession for a limited period, e.g. fifteen days, after receipt of delivery and notice thereof to his customers. At the end of that period, any free securities not called for by the customer would be required to be escrowed.

Pending delivery to the escrow agent, the broker-dealer should be required to segregate each customer's free securities in a manner identifying such customer's securities individually. Further, the broker-dealer ought not to be allowed to commingle a customer's free securities with the securities of any other customer or of the broker-dealer himself, or make any other use of such securities.

In delivering free securities to the escrow agent, the broker-dealer should open a separate account for each customer, rather than a single general account into which all free securities would be placed. This would facilitate the tracing of the customer's securities in the event of the broker-dealer's insolvency.

3. "Safekeeping" Securities

An analogous problem arises in connection with the delivery of securities by a customer to a broker-dealer for safekeeping. In this situation, as in the case of free securities, the broker-dealer has ready access to the securities so that the broker-dealer at all times has the opportunity to convert the securities improperly to his own use.

To insure the customer protection against such abuse and at the same time remove from the broker-dealer the burden of holding securities in safekeeping, it is suggested that a broker be prohibited from taking or holding securities for safekeeping. Provision could be made for the exceptional situation of the departure of clients on extended trips. In the limited instances in which a broker-dealer may be allowed to retain "safekeeping" securities, those securities should be segregated and identified as belonging to a particular customer. Nor should the broker-dealer be permitted to commingle "safekeeping" securities with the securities of the broker-dealer or of any other customer, or make any other use of such securities.

The imposition of a restriction on broker-dealers against accepting securities for safekeeping, except in the limited instance mentioned, will not only afford protection to customers against unscrupulous broker-dealers, but will remove from the legitimate people in the industry the task of performing for their customers a burdensome and expensive service which is more properly a function of a bank or trust company.

4. Hypothecation

(a) Problem:

Although the Commission does not possess detailed information as to the extent of margin or other credit transactions on the over-the-counter markets, the broker-dealer registration statements filed with the Commission reveal that a fairly substantial scattering of broker-dealers carry securities for their customers on margin or other forms of credit.

Under existing law the broker-dealer who has extended credit to a customer may, without consulting the customer, hypothecate the securities on which the credit has been given to the extent of the customer's debt to him. If the broker-dealer wishes to hypothecate a customer's securities for an amount in excess of the debt, the customer's consent must first be obtained. In actual practice, this consent is obtained as a matter of routine when the customer opens an account with a broker-dealer. In fact, it is almost always a condition on opening the account.

Business exigencies require broker-dealers to make loans from banks or other broker-dealers, collateralized by the securities of customers to whom credit has been extended. The mechanical impracticability of making separate loans, each collateralized by the securities of an individual debtor-customer, has bred the practice of making single large loans secured by the stocks of several customers. Almost always the amount of this loan exceeds the debt, or debit balance, of any individual customer, and very frequently exceeds the amount of the aggregate debit balance of all the customers whose securities have been hypothecated. Such a procedure is, at present, legally permissible because of the customers' consents with which the broker-dealer was provided at the time his customers opened their accounts.

Under existing practices, the customer runs a serious danger of loss if the broker-dealer becomes insolvent while the securities are pledged with the bank. The customer can regain his securities from the pledgee only upon payment of the total amount of the broker-dealer's indebtedness to the pledgee. As has been pointed out, this debt will almost always exceed the customer's debt to the broker-dealer, so that any attempt by the customer to regain his securities would be fruitless. Nor is it always possible for the customers whose securities have been pledged for one general loan to regain their securities by pooling their individual debit balances and tendering them to the pledgee, because frequently the amount of the pledge exceeds the aggregate debit balances. The attempt to reclaim securities from the pledgee is often complicated by the failure of broker-dealers to notify the pledgee, or to indicate in their own records, the ownership of the pledged securities, and the nature of the customers' interest therein.

(b) Remedy:

As a measure of protection for investors against the results of excessive hypothecation, while at the same time affording to broker-dealers the flexibility necessary to the conduct of their businesses, the following suggestions are made.

(1) Broker-dealers should be prohibited from pledging the securities of any customer in excess of the latter's debit balance, unless the customer's written consent has been obtained before the particular hypothecation in question. To eliminate the present device whereby the broker-dealer obtains the consent of a customer to excessive hypothecation at the time the account is opened it is suggested that a consent obtained as a condition of opening the account should be deemed ineffective to permit the broker-dealer to hypothecate securities in excess of a customer's debit balance.

(2) If the requirement of obtaining a new consent each time the broker-dealer wishes to make an excessive

hypothecation turns out to be impractical, consideration should be given to a provision that consents shall not be effective for more than a limited period (e.g. three months) and that during that period such consents shall be revocable by the investor upon reasonable notice to the broker-dealer.

(3) In those instances in which proper consents have been obtained, the indebtedness of the broker-dealer to the pledgee should not exceed the aggregate debit balances of all the customers whose securities have been pledged. Thus, in the event of the insolvency of the broker-dealer, the customers involved can reclaim their securities from the pledgee by tendering to him the amount of their aggregate debit balances.

(4) At or prior to each hypothecation, the broker-dealer should be required to supply the pledgee with written notice of the character and extent of his customers' interest in the securities pledged. A similar record shall be retained by the broker-dealer.

The above suggestions, embodying ideas contained in the rules proposed under § 8(c) of the 1934 Act, do no more than bring this phase of the regulation of the over-the-counter brokers and dealers into line with the regulation of persons using the exchanges.

As I have already pointed out, the Commission does not have adequate information as to the extent of margin trading on the over-the-counter markets. A study of this problem should be made to determine whether or not it would be desirable and practicable to promulgate margin requirements for trading in over-the-counter securities similar to those now existing with respect to listed securities.

(5) Commingling:

Elsewhere in this memorandum I have suggested that broker-dealers be prohibited from mingling a customer's "safekeeping" or "free" securities with the sucurities of any other customer or broker-dealer. In certain limited circumstances, provision has been made permitting a broker-dealer to mingle securities held for a customer on margin with the securities of other customers. It seems undesirable to extend this permission. Therefore, I suggest that broker-dealers be restricted absolutely from hypothecating customers' securities under circumstances that will permit such securities to be subjected to the lien of a pledgee if securities of anyone other than a customer of the broker-dealer are also subject to such lien. (See Rule X8c(2)).

(6) Fictitious Quotations:

(a) Problem.

The prevailing quotation systems in the over-the-counter markets are characterized by: (1) Lack of a public or inter-dealer quotation system that records actual sales; (2) The publishing of inter-dealer quotations which are nominal, i.e., there is no firm commitment to effect transactions at the prices quoted; (3) Most quotations to the public are nominal.

The absence of any mechanism for recording actual purchases and sales on the over-the-counter markets effectually prevents a customer from ascertaining the other side of the market without the aid of broker-dealers. The customer thus becomes dependent on the broker-dealer's integrity in not exacting an excessive profit.

The quotation to the public of nominal prices without describing them as such frequently misleads investors into believing that transactions may be readily effected at the quoted prices. Usually, however, when the customer attempts to deal upon the basis of the quoted price, the dealer refuses to do so, and then proceeds to induce the customer to trade on a less favorable basis.

(b) Remedy:

To minimize misconceptions aroused in the investor by the quotation of "nominal" prices without designating them as such, it is suggested that a broker-dealer be required to identify a quoted price as "nominal" and to state that such quote does not represent a price at which he binds himself to effect transactions. Unless prices are marked "nominal", the broker-dealer should be required to effect transactions at the prices quoted. In those instances, the broker-dealer should also be required to state the volume of transactions and the priod of time during which he will effect transactions at the quotations published.

In addition, the offering sheets sent to the public should indicate, with respect to each security offered for sale, whether such security is in the broker-dealer's inventory, is under option to him, whether he is under a firm commitment to purchase the securities or whether the securities are available in the general market.

Despite the obvious desirability of a quotation system that would reveal to investors actual transactions in securities, as is now done in respect to transactions on the exchanges, the physical obstacles, to a feasible mechanism, are considerable. The large number of issues traded in on the over-the-counter markets and the great volume of transactions effected made a ticker system seem unworkable. In addition, there is the problem of inducing newspapers to devote security to security quotations the large amount of space needed to record transactions in the various issues. Further, there is a substantial number of counter securities which are so inactive that a quotation on any given transaction would be no more informative than if there were no quotation based upon an actual transaction.

Several instances have been uncovered by the Commission of brokers and dealers who have systematically issued quotations designed to depress or raise the market on securities or to create false activity or the appearance of activity in securities. The approach to the curbing of such practices might be made by means of a regulation defining such quotations as fictitious, or by a regulation similar to GB4 with approrpriate modifications to suit the over-the-counter markets.

Attention should be directed to the practice of some brokers and dealers of publishing quotations, for a consideration, at the instance of an underwrite, issuer or other broker of dealer (See Sweet Steel case). Although omission to reveal the details of such a situation might constitute a violation of § 17 of the 1933 Act and of Rule MC2, it may be desirable to eliminate such a practice entirely by defining such a quotation as fictitious and forbidding it as such.

(7) Installment Selling:

The extent to which securities are sold over-the counter on an installment basis is not completely known.

The Commission is fully familiar with the sale of participations in underlying investment trusts on a periodic payment basis. The Commission also possesses records of individual broker-dealers who sell all types of security on the installment plan. In the typical installment plan, the customer makes a down payment and contracts to amortize the balance by a series of periodic payments. The investor's obligation is usually evidenced by a note renewable at the end of each period upon payment of the current installment. Upon payment in full, the customer receives delivery of the security purchased. Sometimes, the broker-dealer, instead of extending the credit himself, arranges for a bank to do so.

The major danger to the customer is that the broker-dealer, or the bank, may not purchase the securities at the time the down payment is made. Failure to do so, of course, amounts to bucketing if the relationship between the customer and the other party is one of agency. If the relationship is that of principal, and the dealer fails to make the purchase, the customer is left without protection for his equity, other than the dealer's financial responsibility. Regardless of the relationship between the parties - the broker or dealer should be required to purchase the securities outright at the time the customer makes his down payment. If credit is extended through a third party, e.g. a bank, such third party should similarly be required to pay for the securities in full.

In order to insure receipt of the securities by the customer upon proper performance of his contract, it is suggested that the broker-dealer or the third party be required to escrow the securities as soon as purchased until the terms of the contract are satisfied or breached by the purchaser. Despite the close similarity between sales on installments and on margin one important distinction may counsel different treatment insofar as the broker-dealer privilege to hypothecate the securities in question is concerned.

In the case of the margin sale, the broker-dealer is allowed to hypothecate a customer's securities to the extent of the latter's debit balance. However, to permit a broker-dealer to pledge securities sold on the installment plan for the amount of the unpaid installments might result in situations defeating the avowed purpose of installment selling. Thus, if a broker-dealer who had made such a pledge went bankrupt before the final installment became due, the customer who wished to obtain possession of his securities, would have to pay at once the full amount of the remaining installments to the pledgee. Thus, to protect himself, the customer would be required to make full payment at a time not called for by his original contract with the broker or dealer.

(8) Combination of Investment Counsel Function with that of Broker or Dealer.

(a) Problem

(I) Dealer as Investment Counsellor.

The conflicting interests engendered by the concentration in one person of the functions of investment counsellor and of dealer are real and present possibilities of abuse that may result in serious loss to investors. Thus, a person who operates as an investment counsellor must be held to the standards of a fiduciary in his relations with his clients. He is obligated to see that his customer trades on the most advantageous terms possible. A person functioning as a dealer, however, is governed by the desire to realize the largest possible profit for himself. Obviously, if the dealer is allowed to trade as such with the customers to whom he renders investment counsel, he will be governed by two conflicting loyalties. That he will resolve the conflict against himself is doubtful. The likelihood is that he will render advice colored by the desire to obtain as large dealer profits as possible.

II. Broker as Investment Counsellor.

The investment counsellor who also acts as broker for the customers whose accounts he services is not open to the temptation to which he would be subjected if he functioned as dealer. No desire to reap dealer profits possesses him. However, there is always the possibility, and a very live one among less scrupulous brokers, that the counsellor who is permitted to act as broker may color his investment advice to stimulate customers' trading activity in order to obtain increased brokerage commissions.

(b) Remedy:

The abuses possibly resulting from the combination of the investment counsel function with that of the broker or dealer can best be avoided by requiring the complete segregation of the broker or dealer function from that of investment counsellor. No broker or dealer should be allowed to represent himself as an investment counsellor. Conversely, any person wishing to function as an investment counsel should be prohibited from effecting transactions either as a broker or a dealer. It is not intended by this recommendation to preclude any broker or dealer from disseminating to clients the ordinary advice incident to his activities as a broker or dealer. In such cases, however, he should not be permitted to receive any fee for such advice other than as contained in his regular commission or dealer profit.

(9) Bucketing:

The Commission's files are replete with instances of bucketing, a term here taken at its technical meaning of failure, by a broker to execute his customer's orders. A dealer's failure to carry out his customer's orders is not technically bucketing but is merely a breach of contract.

A major obstacle to protection of the investor where bucketing has occurred is the difficulty of detection until long after the event. Frequently, a broker's bucketing activities are not revealed until insolvency or bankruptcy has caused an examination of his books. By that time, the broker is so far gone financially that he is unable to make restitution. Clearly, then, a mechanism that will afford some measure of protection to the investor must include, first, a means of detecting bucketing as promptly as possible after its commission, and second, a method of compensating the investor where loss has been incurred.

As a method of achieving the first step, viz.

prompt detection of bucketing, the adoption of a procedure along the following lines may be helpful. A broker (A) should be required to state the terms of delivery on the confirmation sent by him to his customer. The confirmation should state further that on A's failure to make delivery on the due date, A will supply the customer with a copy of the confirmation sent to A by the broker or dealer (B) through whom A executed his customer's order. Thus, A will be able to furnish his customer with evidence that he actually executed the order even though he was unable to make delivery as agreed. A's inability to furnish his customer with a copy of the confirmation from B to A will put A's customer on notice that A failed to execute the order.

Attention should be directed to the possibility, through a variation of the insurance device, of affording protection to investors against loss suffered through failure of broker and dealer respectively to execute orders to carry out contracts of purchase and sale. Further study of the question may establish the feasibility of requiring each association to be set up under the Maloney Bill to post a blanket bond, covering all its members, guaranteeing the execution of all orders which have been confirmed to the customer as having been executed. Although the cost of requiring a bond for each individual broker or dealer might be prohibitive, a blanket bond taken out by the association might be cheap enough to be feasible. To be sure that the small broker or dealer will not bear an undue portion of the cost of the bond, it is suggested that the expense be pro-rated among the brokers and dealers according to a given standard, e.g. net worth or net working capital or any other more workable criterion. The merit of this device lies in the fact that the burden of policing the broker-dealer will be placed on the industry itself. This will make for greater care on the part of the association in admitting brokers and dealers to membership and supervising their activities after they have become members. In addition, brokers and dealers will be more alert in their relationships with each other and will be more likely to bring to the attention of the association any instances of bucketing.

The procedure outlined operates by its terms only with respect to members of an association. Lest a premium be placed on non-membership, it might be advisable to require non-members to take out individual bonds conditioned on the same terms as the association's bonds.

10. Doorbell Ringing

(a) Problem

High pressure selling tactics, undesirable at all times, have their most pernicious effects when practiced upon people with little business experience. Calling on people at their homes offers fruitless opportunity for such selling abuses.

Proposals to curb this practice by forbidding house canvassing completely will do much to injure a large field of legitimate business. A substantial portion of securities wealth is in the hands of women and other persons who have no business offices, persons who cannot be reached except by house to house selling. The Investment Bankers Code attempted to reach the abuse by prohibiting solicitation at homes unless the broker or dealer first received the customer's written permission to call upon him. In my opinion the impracticability of any such requirement would render it a dead letter from the outset.

(b) Remedy:

Fundamentally, protection against high pressure brokers, ealers and their salesmen must come from improvement in the ethical standards of the solicitors. In order to prevent at least the crudest and most untrustworthy type of persons from soliciting customers, it is suggested that any one wishing to act as salesman be required to confrom to certain minimum standards. A comprehensive system of registration of salesmen, agents and customers' men should be set up, preferably by the associations to be formed under the Maloney Bill, but if necessary, by the Commission. As basic minima, such a registration system should require:

(1) Information as to the business history of the registrant.

(2) Record of all injunction and convictions arising from securities transactions.

(3) Record of denial, suspension or revocation of any license as broker-dealer, salesman, agent or customers' man by any governmental agency or exchange or association of persons in the securities business.

(4) A specified number of satisfactory character references.

The association should be given broad powers to deny or revoke registration if the application for registration, or any supplement thereto, indicates an unsatisfactory record. Possibly denial or revocation of registration might better be made automatic upon showing of certain facts, e.g., conviction or injunction. Such details can be worked out later. A procedure for appeal to the Commission may be desirable, if not necessary. In any event, no member of an association should be permitted to hire as salesman, agent or customer's man a person who is not registered as such with the association. To reach non-members of an association, the Commission could issue a rule prohibiting such non-member from employing a salesman, agent or customer's man who was not registered with an association.

11. Confirmation and Order Forms

(a) Confirmation forms

Misleading and uninformative confirmation forms are frequently employed by unscrupulous brokers and dealers to defraud customers. Confirmations which read: "We credit or debit your account" or "We have bought or sold for you" do not reveal to the customer the capacity in which the broker or dealer has acted. Other types of weasel-wording are employed to enable the broker or dealer to charge the unwary investor a brokerage fee and to take a profit as principal at the same time. This abuse can easily be corrected by the use of language on the confirmation slip that will clearly and unequivocally describe the relationship between the customer and the broker. Although Rule MC4 requires disclosure as to the capacity in which the broker or dealer is acting, the Commission has not attempted to prescribe the wording to be used. This seems properly to be a function of the associations. Uniformity of language on the confirmations, with the consequent education of investors, could quickly be achieved if the various associations under the Maloney bill were to require their members to use a particular form of confirmation.

(b) Order Forms

Many brokers and dealers use order forms that do not reveal to the customer, before the execution of the order, the relationship between them intended or agreed upon. Frequently this has permitted the less scrupulous broker-dealer to shift his position from broker to dealer or vice-versa, depending upon which status is more advantageous to him in the particular transaction. Frequently, too, the orders are given orally or on order forms which omit important terms of the contract. Opportunity for confusion, misunderstanding, and deliberate deceit will be considerably minimized if a broker-dealer is required to reduce each order to written form setting forth clearly the material items of the order, e.g., the price, the period during thich the order is to remain in force, the title and amount of securities, and, if possible, the due delivery date and the relationship between the parties. If neither of the last two items is known at the time the order is entered, disclosure with respect thereto should be made on the confirmation slip. The customer should, of course, be given a copy of the order.

In connection with open, unexecuted orders, it is suggested that a record of all such orders on the books of the broker-dealer be mailed to the customer at regular intervals, so that orders which may have slipped his memory can be cancelled if so desired.

12. Deliveries

The complications centering around the problem of the time and method of making deliveries, payments and settlements derive in large part from the diversity in procedures in different sections of the country. Because of the almost complete lack of detailed information with respect to the customary handling of deliveries, payments, and settlements, I think it inadvisable at this time to make any specific suggestions as to the treatment of these problems. It is thought that the associations to be set up under the Maloney bill will be the bodies best suited to make a factual survey of conditions thoughout the country. The Commission will then be in a position to give some semblance of uniformity to the diverse, confusing and occasionally conflicting procedures now prevailing in the over-the-counter markets.

On certain questions, however, some general lines of approach may be indicated. A substantial portion of over-the-counter transactions, particularly among less reputable broker-dealers, is characterized by indefiniteness as to the terms of delivery. Thus, at the time a broker of dealer accepts a customer's order, frequently no agreement is reached between the parties as to the terms of delivery; e.g., cash delivery, regular way, or delayed delivery--this because the broker or dealer usually has no knowledge at that time as to how he can obtain delivery from another broker or dealer. However, if the broker or dealer were selling the customer securities which he has on his shelf or under firm commitment or option, he knows at the time that he takes the order how quickly he can make delivery. In this latter class of cases it is suggested that the terms of delivery be required to be stated at the time the order is taken. In cases where it is impossible to state the time or terms of delivery when the order is taken, the broker-dealer should be required to state the terms of delivery on the confirmation slips given to the customer upon the execution of the order.

Consideration may be directed at this time, too, to certain phases of transactions in bonds sold "and interest."

Ordinarily interest begins running in favor of the customer who has purchased such bonds from the date of delivery to him. In many instances, however, a dealer may fail to make delivery to his customer on the due date and still charge him interest until actual delivery takes place; in some cases of this nature, the dealer may not even himself have been charged for interest accruing during the delay. DDespite the absence of factual data, it is felt there are numerous other situations in which dealers pass on to their customers interest charges which the dealers have not themselves paid, or which the customers ought not to be compelled to pay. I suggest the promulgation of a rule which will prevent broker-dealers from charging customers interest beyond the time of actual delivery or the due date of delivery of the bonds, whichever is earlier, and will, in addition, prevent broker-dealers from charging interest in excess of that which they themselves are obligated to pay.

The Commission's attention should also be drawn to the practice of brokers and dealers of failing to make prompt delivery into the accounts of their customers of securities which they have purchased for them, or failing to deliver promptly into the account proceeds from the sale of the customers' securities. In many instances this failure is actuated by the desire or necessity to use the securities or money to meet commitments of the firm accounts or the accounts of other customers. To guard against a practice which contains such potentialities for loss to investors, I suggest imposing restrictions along the following lines:

(1) Where a <u>broker</u> has sold securities for the account of a customer the broker should be required to deposit the proceeds of the sale into the customer's account by the end of the business day following the receipt of the funds by the broker.

(2) Where a <u>dealer</u> has purchased securities from the customer the dealer should be compelled to deposit the purchase price of the securities into the customer's account by the end of the first business day following the execution of the contract of purchase of the confirmation of purchase, whichever is earlier.

(3) If a <u>broker</u> has purchased securities for the account of the customer, or a <u>dealer</u> has sold securities to a customer, the broker or dealer should be required to deposit the securities

into the customer's account by the end of the first business day following the receipt of the securities by the broker or dealer.

13. Discretionary Accounts.

Abuses arising from the handling of discretionary accounts do not require extended discussion here. Our major concern is to curb the conflict of interests which may warp the judgment of a broker or dealer who has discretionary control over the accounts of his customers. Clearly his judgment may be warped by a desire to earn brokerage fees which he can achieve by "churning" the customer's portfolio. In addition, the broker or dealer may desire to unload his own long position or cover his short position by selling to or buying from the account over which he has discretionary control. There are, of course, numerous other examples of conflict of interests.

It is my opinion that the MC rules at present in force are too limited in their scope to afford adequate protection to the customer who has given his broker control over his securities. MC7 merely acts as a safeguard against the "churning" of an account, while MC6 does no more than require a broker or dealer to disclose his interest in any security transaction which he effects with or for the discretionary account. It is my feeling that in view of the many possibilities for abuse in this field additional hedges should be placed around the broker or dealer so as to insure as far as possible the absence of any conflict of interest between the broker or dealer's duty to the customer and to himself. Similarly, where a broker or dealer has discretionary control over several accounts, he may not be able to resolve with fairness to each customer his conflicting duties to those customers. In an effort to restrict as fully as possible the use of discretionary accounts to those fields where the broker or dealer in discharging his duties to his customers will not be hampered by conflicting interests, I suggest that rules be adopted embodying substantially the following ideas:

(1) That a broker or dealer be restrained from effecting transactions with or for the account of a customer in respect to which he has any discretionary control in securities in which the broker or dealer has a long or short position;

(2) That the broker or dealer be prohibited from dealing with the discretionary account in securities in the distribution or accumulation of which thebroker or dealer has a direct or indirect financial interest;

(3) That a broker or dealer be prohibited from effecting transactions with or for the discretionary account in securities in which he holds or has granted any option;

(4) That a broker or dealer be prohibited from effecting transactions with or for the discretionary account in securities in which the principal for whom he is acting holds or has granted any option;

(5) That a broker or dealer be prohibited from effecting transactions between accounts over which he has discretionary control and the account of any other of his customers whether such latter account be discretionary or not;

(6) In order to prevent "churning," that Rule MC7 or some modification of it be retained.

It will be noted that the restrictions mentioned above are absolute and in this respect differ from MC6 or the old MA12 rule. A broker-dealer may avoid restrictions imposed by MC6 by sending to the customer written disclosure of the broker or dealer's interest in the transaction. The restraints imposed by MA12 may be obviated by obtaining the customer's written consent to the transaction in question. I feel, however, that no undue stricture will be placed upon the broker or dealer if he is prohibited absolutely from acting in those situations where his self interest conflicts with the interest of his client. There would still be a sufficiently large sphere of activity in which the broker or dealer might operate profitably. The only risks to which the customer would then be subjected would be the risk of incompetency upon the part of the broker or dealer, a risk to which the customer knowingly subjects himself when he gives a broker or dealer discretionary control over his account.

In the past a good deal of laxity has prevailed with respect to the type of person to whom discretionary power has been given. Thus customer's men, office managers and other employees of a broker or dealer have frequently been allowed to handle accounts in their discretion, men who in numerous cases do not possess the experience and background necessary for a wise handling of the account. To afford investors some degree of protection against this hazard, I feel it might be desirable to require all transactions with or for a discretionary account to be approved in writing by a partner, principal officer, or person occupying a similar position of the firm which is handling the account. Such written approval would require nothing more than the initial of the parther or pincipal officer.

Finally, there may be instances in which misunderstandings will arise between the broker or dealer and the customer as to the scope or the broker or dealer's discretionary power. It might be desirable in order to prevent such confusion from occurring to require the broker or dealer and the customer to enter into a written agreement, at the time the account is opened, setting forth the terms upon which the account is to be operated.

13. Financial Statements, Reports and Records

A partial list of records to be kept and statements to be filed by brokers-dealers is set out below. This list will be supplemented as rules and regulations are drafted.

(a) All broker-dealers who pledge customers' securities should file with the pledgee:

I. A record showing the character and extent of each customer's interest in the securities pledge.

II. If the amount of the pledge exceeds the debit balance of any customer, a copy of the written consent of each each customer.

(b) Complete records of all loans from banks or others should be kept by the broker-dealers. All collateral loans for the account of customers should be recorded to show the name of the lender, the amount of the loan, the exact description of collateral, including the number of shares pledged, the registered holder, the certificate or bond number, the name of each person and the account out of which each piece of collateral came.

(c) All broker-dealers who are members of an association to be created under the Maloney bill and who extend credit should file with such association periodic audited statements of condition. The associations should, in addition, have the power to make surprise audits of all the books of all members, whether or not they extend credit. Despite the undesirability of imposing restrictions on association members which are not also imposed on non-members I am dubious of the feasibility, under existing personnel limitations in the Commission, of requiring non-members of the association to file similar reports with the Commission.

(d) All broker-dealers should be required to send to their customers:

I. Monthly statements of account.

II. Periodic statements of unexecuted open orders still in force.

III. Copies of all orders and all agreements entered into with such customers.

IV. In the case of failure to make delivery on the due date, a copy of the confirmation sent to the customer's broker-dealer by the broker-dealer through whom the former executed his customer's order. As already indicated failure to supply such a confirmation will put a customer on notice that his order has been bucketed.

15. Step-up Offering Price

Sometimes encountered is the practice of offering securities over a given period of time at gradually increasing prices during the primary distribution of the issue. In the instances involved the only reason for the step-up and the reason which is frankly stated in the registration statement is to stimulate customer activity as early as possible. If full disclosure for the step-up is made, it would seem that the philosophy of the Securities Act of 1933 is satisfied.

It is suggested that any attempt to curb such a practice would more properly involve a revision of the Securities Act rather than action under the Maloney bill.

16. Aggregate Indebtedness

For some time the Commission has been studying the desirability and feasibility of imposing certain financial restrictions on brokers and dealers in an effort to minimize insolvencies. These restrictions have taken two forms: (1) prohibiting brokers and dealers from acting as such unless they possess a certain amount of capital; (2) prohibiting brokers and dealers from acting as such if the ration between their aggregate indebtedness and net capital exceeds a certain percentage.

Since this problem, insofar as it relates to members and membrodes, has been the subject of considerable study by Mr. La Padula and his associates, and since the problem as it bears upon over-the-counter brokers and dealers is in some respects very similar, no discussion of the over-the-counter aspect will be entered into here.

Memorandum prepared by:

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