

SEC Study  
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**OFFICIAL REPORT OF PROCEEDINGS**  
**BEFORE THE**  
**SECURITIES AND EXCHANGE COMMISSION**

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Docket No. \_\_\_\_\_

In the matter of \_\_\_\_\_

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Place \_\_\_\_\_

Date \_\_\_\_\_

Pages \_\_\_\_\_

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BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

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In the Matter of: :

SPECIAL STUDY OF SECURITIES MARKETS : :

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Tariff Commission Hearing Room,  
 7th and F Streets, Northwest,  
 Washington, D. C.

Wednesday, May 16, 1962

The above-entitled matter came on for further  
 hearing, pursuant to recess, at 10 o'clock a.m.

BEFORE:

MILTON H. COHEN, Study Director and  
 Presiding Officer.

APPEARANCES:

(The same as heretofore noted.)

P R O C E E D I N G S

The Presiding Officer: The hearing will be in order. Let the record show that the hearing today is a continuation of the hearings commenced on Monday, May 7, and recessed on Friday, May 11, until this date.

Will you proceed, Mr. Paul?

Mr. Paul: Mr. Presiding Officer, the first industry witness for today is the firm of Merrill Lynch, Pierce, Fenner and Smith, Inc., Mr. Donald T. Regan, Vice President and Secretary, and Mr. James Thomson, Vice President and Treasurer will testify as a witness. They are represented by Mr. James Walker, General Counsel, and Mr. Louis Eten, of the firm of Brown, Wood, Fuller, Caldwell and Ivey. Mr. Frederick Moss of the Study Staff will conduct the questioning.

Whereupon,

DONALD T. REGAN

JAMES THOMSON

were called as witnesses, and having been first duly sworn, were examined and testified as follows:

The Presiding Officer: Gentlemen, in all Commission proceedings it is customary to advise the witnesses of their Constitutional privilege. Since you are represented by counsel, I assume you are aware or will be advised by your counsel of your privilege and if at any time you have any question about exercising your privilege, you may, of course,

consult with counsel. Proceed.

DIRECT EXAMINATION

Mr. Moss: Mr. Regan, will you please state your name for the record?

Witness Regan: Donald T. Regan.

Mr. Moss: I understand, sir, that you have an opening statement to make.

Witness Regan: I do.

Mr. Moss: Will you please proceed?

Witness Regan: My name is Donald T. Regan. I am a vice president, a director and a member of the executive committee of Merrill Lynch, Pierce, Fenner & Smith Incorporated. The business of my firm consists of acting as a broker and dealer in securities and commodities, and as an underwriter and distributor of securities. We conduct our business through 150 offices in the United States and several foreign countries. Our home office, which is located at 70 Pine Street, New York City, consists of seven divisions made up of 45 departments. Each division is headed by an officer who also is a member of our executive committee, and whose full time is devoted to his administrative and supervisory responsibilities. None of them services accounts. Our personnel totals 8,700 of whom over 500 are engaged in management and supervision. We are members of 41 securities and commodities exchanges. Our annual report for the year 1961,

copies of which are available to this study group, reported our total assets at \$796 million and the capital of our company at \$90 million.

Until January 1959 our firm conducted its business as a partnership. At that time we incorporated. One result of this change is that we now have three times as many stockholders as we had partners and all the additional new owners are full time employees of the company. Another result of incorporation has been to provide great financial strength and a continuity of the capital of the firm, which we feel is very important to members of the financial industry who deal with the public. The stock in our company presently is owned by 329 holders--including an interest of about 10 per cent held by the Charles E. Merrill Trust, the beneficiaries of which are educational, religious and charitable institutions. We expect to continue to broaden the ownership of our firm.

In 1961 we handled 12.7 per cent of the public round lot volume and 20.2 per cent of the odd lot volume on the New York Stock Exchange. Those percentages are about the same as in 1957 despite the fact that in the succeeding four years we added more than 20 offices.

It is estimated that there are 15 million shareholders in the United States. This is almost three times the number in 1948. This threefold increase in the number of share owners in the United States is unquestionably an indication that our

free private enterprise system is functioning for the benefit of the people, whether they be doctors, lawyers, ministers, school teachers, farmers, workers, housewives or retired people. Their financial circumstances vary from those who are wealthy to those who just have reached the point where they are able to invest in the future of American industry. I might add that as part of our philosophy we feel that before investing in securities any individual should have adequate insurance and a cash reserve to meet emergencies.

While citizens of the United States should be gratified at the broadening of the ownership of American industries, the people in the investment business must recognize that it imposes certain responsibilities on them. Merrill Lynch recognized long ago that the responsibilities inherent in dealing with people and their money are not to be taken lightly.

I feel it might be appropriate for me to familiarize the study group, as briefly as possible, with some of my firm's basic business policies and some of our more important practices.

In 1941 Merrill Lynch published the first annual report of operations ever made public by a member of the New York Stock Exchange. In that report we gave a statement of policy. Over the years those policies have been modified in some cases, but in principle they are unchanged. Because they

reflect substantially something of our philosophy of doing business, I am including them in this statement.

The interests of our customers must come first.

We make no service charges.

In any printed report from our research division on any company we disclose the general size of any stockholdings that our firm or any of our offices might have in that company.

Whenever we participate in a public offering of securities, no stockholder, officer or employee of our company is permitted to buy until orders of our customers have been filled.

None of our stockholders, officers or employees is permitted to benefit personally from advance knowledge of information about securities or commodities which the firm has obtained for the use of its customers.

To assure financial soundness, we will maintain our capital in an amount which exceeds the requirements imposed by regulatory authorities.

We publish an annual report which includes a statement of our income and expenses, as well as a statement of our financial condition.

We aim to provide the most efficient service any broker can offer to assure customers of fast and accurate handling of their business. All our commissions are at minimum levels.

Because we believe that the ownership of securities by more and more people is desirable we maintain a broad program of public education, explaining what it means to invest and how to go about it.

Because we believe in "Investigate --Then Invest," we offer large and small investors the help of our research division at no charge whatsoever.

Not only do we have policies, but we do our utmost to live up to those policies. The implementation of policies is as important as the policies themselves. We must, therefore, look first to the people who must adhere to the policies, because an organization is composed of people. Merrill Lynch people are selected for different positions, whether the position is that of account executive, cashier, wire operator, office manager, or any other, because we feel they have the basic qualifications for the particular duties they are to perform. To be selected for the position of an account executive at Merrill Lynch an individual must have a good educational background, preferably in economics or business administration. Before he is selected to enter our account executive training program, an applicant is very carefully screened and tested. More applicants are rejected than are accepted. From over 50,000 applicants in 16 years only a little more than 2,000 have been selected. The man who is selected is given a comprehensive background and training

before he is permitted to act as an account executive.

Our account executive training school, which we originated in 1945, has its own complete teaching staff. Our 80 instructors are competent people from both within and outside our company. They include lawyers, certified public accountants, college professors, and our own officers and department managers. The period of in-school and on-job training received by the account executive covers a period of over a half year, but because it is so intensive we have been told the training received is more comprehensive than that received in a graduate school. Our cost of this training program last year was \$1-1/2 million, which includes salaries paid to the trainees.

Of the approximately 2,000 account executives we now have, about two thirds are graduates from our training school. Our account executive turnover rate, excluding retirements and deaths, is less than 5 per cent a year. That would seem to be a good indication that a man who becomes an account executive at Merrill Lynch does so on a career basis.

Our training is not confined to prospective account executives. Our research division carries on its own formal training program which usually covers a period of about 1-1/2 years. Our operations managers who supervise the clerical activities at the offices also receive special training through a formal program.

After people are trained for their positions, operating procedures and policies to guide them in the daily performance of their duties are given to them. Our operating policies and procedures are, in effect, a statement of our rules and regulations for doing business.

Just as public laws require law enforcement agencies, a business must provide supervision to see that its policies and procedures are followed. The matter of supervision is one on which Merrill Lynch places great emphasis. Because of the nature of this Commission's study I will not go into the subject of supervision of our home office departments, but I do want to say something about supervision at our offices.

Merrill Lynch operates on the principle that responsibility and authority should be placed as close as possible to the place of operations. Each office manager has the responsibility and the commensurate authority for the operation of his office within the framework of our policies. Under his supervision are the account executives who service customers' accounts and the operations personnel who handle the clerical details of processing transactions within the office. To assist him in supervision of the operations personnel the office manager has an operations manager. As a general policy our office managers are not permitted to service customers' accounts. The office manager's function is to manage the office which means that he is concerned

primarily with administrative and supervisory duties and responsibilities. This we have found to be the most effective means to insure supervision of accounts and supervision of the activities of the employees of the office. We believe that the proper indoctrination of the manager is a most important factor in insuring compliance with regulations and our policies and procedures. Our 150 managers are trained and experienced in the investment business. Their average age is 47 and they have been in our employ for an average of 18 years.

Our office managers are carefully selected. As a rule a manager of a smaller office comes from the ranks of our account executives and he will have had at least eight to ten years' experience with us. After selection he is brought to the home office for the manager training program. Managers for larger offices are usually promoted from among the managers of smaller offices.

We feel that careful indoctrination in the principles on which our firm operates is most important because the office manager must in turn communicate our philosophy of doing business to the people under his supervision in the office. A manager's training, therefore, is a continuing process.

We do not let supervision begin and end within the office. We continually check the effectiveness of our supervision. For example:

1. A staff of traveling auditors makes a surprise procedure and policy audit of each office at least once a year.

2. From the very start of this firm we have always had a division director responsible for policies and procedures designed to require adherence to regulations, policies and procedures. As our business and personnel expanded, additional people were continuously added to this division.

3. Scheduled visits to the offices are made by home office executives and officers, as well as scheduled visits to the home office by office managers and account executives.

4. A special department whose staff spends the greater part of its time in extended visits to the offices is maintained by the firm for the purpose of observing its management and account executives.

5. We have our own internal auditing department consisting of 27 men.

6. Personal accounts of employees, including officers of the company, are continually examined.

7. Seminars are held periodically at the home office for office managers. These seminars include, among other things, reviews of our operating policies and procedures. To date, the seminars, which last for a period of 1-1/2 to 2 weeks each, have been attended by 109 office managers. Incidentally, this month we completed the seventh seminar in 2-1/2 years.

8. In addition to the foregoing, in accordance with NYSE requirements, we have an annual surprise audit made by an independent firm of accountants, and also annually a thorough examination of our records and procedures is made by auditors of the New York Stock Exchange.

Responsibility is not one-sided. The investor also has responsibilities. For one thing, just as a patient should give his doctor all the facts, so that the doctor may prescribe intelligently for him, so the investor should give his broker all pertinent financial facts. Only in that way can the account executive or the broker do the best job of meeting an individual's investment objectives. We believe the individual investor also should be aware of and be familiar with the different types of investment objectives and that he should investigate before he invests.

While those are responsibilities of the individual investor, they in turn impose an additional responsibility on the investment firm and that is to provide the investing public with some means of acquiring at least some basic knowledge concerning investing. Merrill Lynch for many years has maintained a broad program of public education explaining what it means to invest and how to go about it. Our program is carried through advertising, public forums, lectures, T. V. programs and various basic booklets concerning investing.

I have attempted to give you briefly some of our firm

beliefs, namely, that the ownership of securities by more and more people is desirable for our economy; that an account executive in order to service an investor properly must have a thorough knowledge of investment and finance which is best acquired through intensive study and training; that the account executive must be an individual with high ethical standards and that in all his dealings his first consideration should be what is best for the client. We are convinced that an office manager at Merrill Lynch should above all things be a manager and a supervisor. We believe the big increase in the number of investors means an increased responsibility on the part of our industry to see that the investor knows something about investing.

I wish I could conclude this statement by saying that we have an absolutely perfect operation. However, as I said earlier, an organization is composed of people and where the human element is involved there will be occasional lapses in performance. Fortunately such cases are very few, but if one does come to light we take vigorous action. We constantly look for ways and means to improve our procedures, our management and our supervision.

Merrill Lynch has been and will continue to be aware of its responsibilities.

Thank you.

The Presiding Officer: Mr. Regan, in your statement

of some general principles at the outset of your statement, and in the course of your statement, are you referring essentially to what is appropriate for your firm, or do you care to comment on how much of what you talked about you consider appropriate for securities firms generally, even though they are not the largest in the country?

Witness Regan: Since we believe that these policies are good for Merrill Lynch, our thinking would be that these policies, while we wouldn't want to see them enforced by other people than Merrill Lynch as strictly Merrill Lynch policies, would be the same type of policies that other firms could adopt.

The Presiding Officer: Do you think they are appropriate policies and might well be enforced by the firms themselves or other agencies?

Witness Regan: Yes.

The Presiding Officer: You talked about the fact that all of your commissions are at minimum rates. You are talking about commissions on transactions on stock exchanges?

Witness Regan: And in the over the counter markets. In the over the counter markets our commission schedule is the same as the New York Stock Exchange minimum commission rate.

The Presiding Officer: So in all over the counter transactions you use the same commission rates as if it were a stock exchange transaction?

Witness Regan: Where we act as agent. However, we do act as principal over the counter.

The Presiding Officer: In other words, your statement does not mean that you always act as agent with these commission rates. You do also act as principal?

Witness Regan: We do, sir.

The Presiding Officer: And there you would apply the market cost markup policy?

Witness Regan: Yes, sir. Our markup policy is the Stock Exchange commission to the next highest eighth. As an example, if the commission were \$32 for a hundred shares, our markup would be three eighths of a point or 37.50.

The Presiding Officer: This is a uniform practice for all over the counter principal transactions?

Witness Regan: In Merril Lynch, yes, sir.

The Presiding Officer: Going back to the Stock Exchange commissions, when you say that you always use the minimum commission rate, isn't that a pretty prevailing practice among stock exchange firms? In other words, isn't the minimum scale essentially the maximum scale at this time for all transactions?

Witness Regan: I wouldn't know about all firms but the largest firms, that we know of, as a rule do use the minimum commission schedule as the maximum, yes.

The Presiding Officer: Go ahead.

Mr. Moss: What would you say your average markup was on a principal transaction for your firm?

Witness Regan: Since the New York Stock Exchange commission schedule is an average mark up of around one to two per cent in the over the counter transactions, ours would be in the same category, one to two per cent.

Mr. Moss: Can you tell us, sir, what your position is with Merrill Lynch?

Witness Regan: Yes. I am Director of the Administrative Division, and also secretary of the corporation.

Mr. Moss: What are your duties and responsibilities generally?

Witness Regan: Under the Administrative Division of Merrill Lynch comes our personnel department, including our training school, our legal department, our administrative liaison department, which is a supervisory department, our auditing department, which is our own internal auditing department separate and distinct from our accounting department and from the office of the comptroller, our planning department, which plans all of Merrill Lynch's future, and last but by no means least, our corporate affairs department, which is really the office of the secretary which handles our stockholder relations and the like.

Mr. Moss: I note from your opening statement that you say that "from the very start of this firm we always have

had a division director responsible for policies and procedures designed to require adherence to regulations, policies and procedures." Is that your position?

Witness Regan: That is my position now.

Mr. Moss: What was your experience before assuming your present job, briefly?

Witness Regan: I graduated from Harvard College in 1940. After a brief attendance at the Harvard Law School I left to join the United States Marine Corps. Five and a half years I was a regular Marine, now having the rank of lieutenant colonel, retired. In 1946, I entered Merrill Lynch's training school. After the training school, I was an account executive here in the Washington office of Merrill Lynch. Then I became a member of the first sales liaison team at Merrill Lynch. Then subsequently assistant to the director of sales at Merrill Lynch. Then manager of Merrill Lynch training department. Then manager of Merrill Lynch Philadelphia office, and now presently division director.

Mr. Moss: Tell me, sir, during your opening statement and in your answer you gave, you referred to account executive. We have heard testimony in the past week about RR, registered representatives, salesmen, producers. How does an account executive fit into that scale? Is that just another name for salesman?

Witness Regan: Account executive is our name for

registered representative.

Mr. Moss: ; It doesn't imply anything more than a registered representative?

Witness Regan: We think it does. It has connotations, to us, at least, above that of registered representative.

Mr. Moss: What would they be, sir?

Witness Regan: The career aspect of the job, the fact that it is not just another salesman, that type of thing, more of a professional thing.

The Presiding Officer: Do you have some registered representatives who are not account executives?

Witness Regan: Yes, we do. These, however, are mostly women who are assistants to account executives who do not handle customers' accounts. They are also registered representatives who are trainers and the like who must be registered with the Stock Exchange.

Mr. Moss: Would it be fair to say it is somewhat of a statutory symbol calling a person an account executive?

Witness:Regan: Those are your words. Yes, I go along with that.

Mr. Moss: How long have you been calling your registered representatives account executives?

Witness Regan: Since the firm was founded in 1940.

Mr. Moss: Your firm was the largest member firm on

the New York Stock Exchange in terms of retail business, is that right, sir?

Witness Regan: In terms of retail business. I don't want to quibble with you, but we don't do retail business on the New York Stock Exchange. In terms of members of the New York Stock Exchange, yes. When it comes to retail business, we rank sixth in underwritings. I am not sure -- I think there is another member firm, for example, Morgan Stanley, who rates ahead of us in the size of underwritings.

Mr. Moss: Does your firm have the largest number of account executives or registered representatives for any member firm?

Witness Regan: Yes, they do.

Mr. Moss: Just to give us a comparison, do you have any idea whether the next largest firm has half as many registered representatives, a third, or ten per cent less?

Witness Regan: Our feeling is that Bache and Company is probably second in size to us. I am not sure what Harold Bache testified to as their number. We have 2,054 account executives at this point.

Mr. Moss: I believe Mr. Bache stated he has 1500 salesmen.

Witness Regan: 1500?

Mr. Moss. Can you tell me the number of exchanges that your firm is a member of?

Witness Regan: We are members of 41 security and commodity exchanges.

Mr. Moss: I believe you testified that you had approximately 150 offices, is that right, sir?

Witness Regan: That is correct, 150 offices.

Mr. Moss: Some located in foreign countries?

Witness Regan: There are 17 outside the continental limits of the United States.

The Presiding Officer: Mr. Regan, how many of those 41 exchanges are national securities exchanges, approximately?

Witness Regan: May I take the time to count them? I have the list here.

The Presiding Officer: Yes.

Witness Regan: Ten, sir.

The Presiding Officer: And the balance would be commodities exchanges and exchanges in foreign countries?

Witness Regan: And exchanges in foreign countries, yes, sir.

Mr. Moss: Just to get some idea as to the growth of your firm in the past ten years, can you tell us approximately, just give me an approximate number of branch offices that Merrill Lynch had, say, in 1951 or 1952?

Witness Regan: In 1951 we had 106 offices.

Mr. Moss: So that you have increased your offices approximately 50 per cent in the last ten years?

Witness Regan: Approximately, yes.

Mr. Moss: Approximately how many account executives did you have ten years ago?

Witness Regan: A thousand and 38.

Mr. Moss: Now you have?

Witness Regan: 2,054.

Mr. Moss: So you have increased the number of account executives, doubled approximately?

Witness Regan: About double.

Mr. Moss: Now, can you tell me what your gross income was for 1961?

Witness Regan: 1961 our gross income was \$181,141,000.

Mr. Moss: How has that grown in the past ten years?

Witness Regan: In 1951 our income was \$44,300,000.

Mr. Moss: That is approximately a four-time growth?  
Quadrupled?

Witness Regan: Quadruple.

Mr. Moss: Would the figures on net income be approximately the same?

Witness Regan: Yes. We are the one firm that does give our net income. I am not hesitant at all about giving that. Let us see, after taxes and employee contributions, \$2,500,000 in 1951. Last year, \$22,100,000.

Mr. Moss: So that you have increased your net income tenfold in the past ten years?

Witness Regan: Almost tenfold.

The Presiding Officer: Can you give some figures as to the comparative increase in stock exchange business and over-the-counter business in this period? Just some rough indication.

Witness Regan: We could probably do it this way. In 1951 we did 11.3 per cent of the public round-lot business on the New York Stock Exchange. Last year we did 12.7 per cent. In odd-lot business, we did 15 per cent in 1951. Last year we did 20.2 per cent.

The Presiding Officer: In dollar volume can you give some indication of how the dollar volumes increased in

this period in the over-the-counter sales?

Witness Regan: We were unable to furnish the study with our figures for 1949. They weren't available. We gave the figures for 1955 in accordance with the study. As I recall, they indicated in terms of market value over-the-counter about a half billion dollars in 1955. 1961, 2.4 billion dollars of market value.

The Presiding Officer: Did you have any estimate for the 1949 or 1950 or 1951 era?

Witness Regan: We tried for some figures, but they didn't seem to jell. My guess would be they would be on the order of 250 to 300 million in 1949.

The Presiding Officer: As compared with what in 1961?

Witness Regan: As compared with 500 million in 1955, 2.4 billion in 1961.

The Presiding Officer: Go ahead.

Mr. Moss: Approximately how many customer accounts does Merrill Lynch presently have?

Witness Regan: We sent out 520,000 statements in the month of April. We probably would have more customers than that because the accounts that were sent out were people who had either a position or money balance or activity during April. If there were none of that, they would not have received a statement.

Mr. Moss: Would you say 550,000 customer accounts?

Witness Regan: We have over 800,000 stencils, active stencils in our stencil files.

Mr. Moss: Say in 1951 approximately how many customer accounts did you have?

Witness Regan: I don't know whether I have any figures on that. May I take a moment to check?

Mr. Moss: Sure. If not, give us your best estimate.

Witness Regan: As a rough guess, 200,000.

Mr. Moss: Your annual report says that in 1940 you had approximately 48,000 customers.

Witness Regan: That is correct.

Mr. Moss: And you believe you had somewhere around 200,000 in 1951?

Witness Regan: That is right.

Mr. Moss: Now you stated what your gross and net income figures were. Could you state briefly and generally what your sources of income are?

Witness Regan: Our primary source of income is our listed business. The second source would be our unlisted securities. Third would be our underwritings. Fourth, our commodities. And fifth, our municipal bond business.

Mr. Moss: Do you also have a source of income as interest paid by customer?

Witness Regan: Yes, we have interest paid by

customer.

Mr. Moss: Is that a sizeable portion of your income?

Witness Regan: A reasonable size, yes.

Mr. Moss: Approximately can you tell us something about interest paid by customers? How the interest is paid by customers?

Witness Regan: Interest is paid by customers to us on their debit balance in margin accounts. Buying on margin, as you probably know, is similar to buying on time, buying a house, where you put a downpayment, the broker lends you the rest of the money. Currently you put up 70 per cent, the broker lends you 30 per cent. These margin debits we charge interest on.

Mr. Moss: What is the rate of interest?

Witness Regan: The minimum rate now is 5 per cent. Maximum is 6, by the way.

Mr. Moss: For the year 1961 do you know how much interest was paid into Merrill Lynch by customers?

Witness Regan: 19 million dollars.

Mr. Moss: Thank you.

Mr. Regan, it has been said that Merrill Lynch is modeled after a chain store operation. Can you explain that for us and all that it implies?

Witness Regan: Yes. I don't know who the author of the statement is, but Charles Merrill, who was one of the

founders of Merrill Lynch, Pierce, Fenner and Smith, started in Wall Street as an investment banker. One of the early specialties that he developed even prior to World War I, and of course definitely World War I during the 20's, was the development of the chain store and the financing of chain stores. Such chains as we know today, as J. C. Penny, Newbury, S. S. Kresge, the various shoe companies that are chains.

He also went into such chains as Safeway Stores. He financed First National Stores, all of those chain stores. He became known as a chain store investment banker.

In 1940 when he was merging the firms of Merrill Lynch, E. A. Pierce, and later Fenner and Beane, he decided that the branch office operation should have many similarities to chain store operation. That is, a large number of branch offices centrally controlled and managed from the home office.

Mr. Moss: Was the idea to appeal to a broad range of the public or a broader range of the public than investment banking houses and brokerage firms had been appealing to prior to that?

Witness Regan: Yes. But there was a whole system devised at that time of public education for potential investors. What the firm did in 1940 was to make a survey of the present customers, of E. A. Pierce in the Los Angeles area. They wanted to determine what it was about brokers that people did not like. Our policies were based upon

the fact that to overcome these objections, one of the things we found that people needed was to know something about securities and how to find it out in a simple manner, without the necessity of piling through numerous volumes in order to understand how to buy and sell securities.

Mr. Moss: I take it one of the purposes was to interest people who were not previously investors to become investors in the securities markets?

Witness Regan: That is correct.

Mr. Moss: You said that this chain store idea involved central control. You also talked about autonomy of the branches. How do you reconcile central control and autonomy of the branches?

Witness Regan: The branch is supervised by the manager. He is on the spot. He knows what is going on in his own shop. In the home office, it is up to the home office to supervise his level of supervision to make sure that he is supervising and carrying out. In addition, my inference there was that we also believe in central bookkeeping, and we do all of our bookkeeping centrally in the home office.

Mr. Moss: Tell me, Mr. Regan, how does the division you head fit in with the overall organization of the firm?

Witness Regan: There are seven divisions in Merrill Lynch. I won't select them in any particular order, but just as they come to mind. I will try to describe them

briefly for you.

Mr. Moss: To save time maybe you should describe only the division concerned with training, supervision and selling practices.

Witness Regan: That is the administrative division. That is my own. The administrative division, as I said before, is broken down into six departments. Do you wish me to name them again?

Mr. Moss: No. Do any of the other six operating divisions which you referred to have any concern or control over or responsibility in the area of training, supervision and selling practices, other than your own division?

Witness Regan: Of whom? They have the responsibility for training and selecting their own personnel and they have the responsibility for supervising their own personnel.

Mr. Moss: We are talking about the account executives and people who deal with the public in selling securities.

Witness Regan: You are talking about them. Excuse me, I didn't hear you. I have a ring in my ear. The operations division, of which Mr. Thomson is director, operates in the area of account executives insofar as the traveling auditors who annually make a surprise visit to each office come under him. Mr. Thomson also has the cash and margin department under him, which, of course, is

concerned with the enforcement of Regulation T.

The sales division has quite a bit to do with the selection and the training of office managers and accordingly they come in on that end. The sales division also has a special department which makes visits to offices and which come back and report to the home office on what is going on in the offices. So they, too, are concerned in supervision.

The Presiding Officer: Excuse me, Mr. Moss. Are the research activities centered in New York or are the research activities around the country in the branch offices?

Witness Regan: The research activities are primarily in New York. We do have branch research facilities in Canada for Canadian securities and Geneva, Switzerland, for European securities. Other than that, it is all concentrated in New York.

The Presiding Officer: How about the trading markets? Do the over-the-counter trading markets exist in various of the branch offices, or is that done entirely in New York?

Witness Regan: That is controlled in New York and the primary trading department is in New York. We do have branch traders in such offices as Los Angeles, Chicago, San Francisco, and the like. But their activities are supervised first of all by their office manager and secondly by the trading department in New York.

The Presiding Officer: Would there be recommended lists or accepted lists of securities for different branch offices, or is that all centralized in New York?

Witness Regan: You mean for traders to trade?

The Presiding Officer: Yes.

Witness Regan: That is controlled strictly from New York.

The Presiding Officer: And for salesmen to sell, the same thing?

Witness Regan: Yes, definitely. You are referring here, I take it, to over-the-counter securities?

The Presiding Officer: Yes.

Witness Regan: Yes, sir.

Mr. Moss: As secretary and vice president for the administrative division, who do you report to?

Witness Regan: The president and the chairman of the board.

Mr. Moss: There is no executive committee?

Witness Regan: Yes, I am a member of the executive committee. The seven division directors, one other person, plus the president and the chairman of the board make up the executive committee.

Mr. Moss: But you generally report to the president and the chairman of the board?

Witness Regan: Yes.

Mr. Moss: Now, as I understand your table of organization, the branch offices report directly to the president, is that correct?

Witness Regan: That is correct.

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Mr. Moss: What are they reporting to the president?

Witness Regan: That is reporting as far as terms of control is concerned. In other words, the only one who has the right to hire and fire an office manager, to discipline an office manager, and has the ultimate responsibility for the actions of the office manager is the president, and then the chairman of the board.

Mr. Moss: Does the branch office manager make formal reports on a regular basis to the president?

Witness Regan: Yes. We require a written report, quite a comprehensive report each year in writing.

Mr. Moss: And this has to do with the operations of his branch, is that right?

Witness Regan: That is correct.

Mr. Moss: Does the president have other duties?

Witness Regan: Yes, he does.

Mr. Moss: Yet he can keep track of 150 branch offices and he is the only one that is keeping track of these people or am I missing something?

Witness Regan: There are seven divisions keeping track of the offices in various capacities. The sales from the sales point of view. I am keeping after them from the point of supervision. Mr. Thomson is keeping after them from the point of view of the back office procedures.

Mr. Moss: You don't have the ultimate authority

over them. That is vested in the president.

Witness Regan: That is right.

Mr. Moss: So if you find something wrong, something that is improper or something you think is against Merril Lynch policies, you then report to the president and say that branch No. 77 is not operating properly.

Witness Regan: That is an oversimplification of it. What we actually do is that if we find something wrong we discuss it immediately with the manager. I am sure if he talks to Mr. Thomson about something wrong on his operations he is not just going to sit still until our president calls him. He will do something about it. The same thing with the other branch managers. Ultimately the responsibility does lie with the president.

Mr. Moss: So the other divisions do communicate with the branches and give them advice from time to time.

Witness Regan: Definitely.

Mr. Moss: But they can't punish them, discipline them or give them direct orders, so to speak.

Witness Regan: Yes. I would use the adverb constantly in communication with them.

Mr. Moss: Did there come occasions when the branch manager disagreed with what a division suggests and then I take it the matter is resolved by the president?

Witness Regan: That would be correct.

Mr. Moss: • So as an example, if one of the divisions, say your division, tells the branch manager, "I think you have been trading too many speculative issues, I think you should cut it down," and the branch manager disagrees with you, it is not a matter for the president. You can't direct him to stop trading a number of speculative issues in a given situation.

Witness Regan: I cannot recall any instance where that has ever happened, where a manager and a division director go down on the mat and put it up to the president who is right.

Mr. Moss: I take it from what you have said so far that the branch manager is the key operating man in the Merrill Lynch organization in terms of basic supervision and basic selling practices and the like, is that right?

Witness Regan: That is correct.

Mr. Moss: Can you tell me or tell us how a new branch office is generally started? By that I mean do you usually pick up another firm or do you ever pick up another firm or do you just go into a new city and open an office that is now a Merrill Lynch office?

Witness Regan: Usually we go into a city on our own. That is, we don't merge with another firm or take over another firm. We, of course, select the city with great care. Naturally since we are business people looking at it from its potential and things of that nature. Having selected

a city, we select a manager to represent us there. Then with the advice and help of our personnel department, he sets about recruiting a staff. We also give him some experienced men to accompany him.

Mr. Thomson will provide for him an operations manager. He will also start recruiting a staff of operations people for that office.

Mr. Moss: Is the manager always a Merrill Lynch man when the office is opened?

Witness Regan: Always.

Mr. Moss: So it is somebody who has been through the Merrill Lynch training program and has worked at Merrill Lynch in some phase or another before he is put in charge of an office.

Witness Regan: That is correct.

Mr. Moss: How about the salesmen? Let us say you open an office in Texas -- Dallas -- would you recruit people from Dallas area who have had experience in the securities business, or would you only take people with experience in Merrill Lynch, and then put new trainees in there? How do you staff an office with account executives?

Witness Regan: We do not attempt to get salesmen from other firms. I can't say the reciprocal of that is true, by the way. We will select Merrill Lynch people, several experienced ones, the remainder training school graduates

who will be given the regular training program before they would go into the new office.

Mr. Moss: So that basically you don't look around in the area for salesmen who have a customer following and then get them for Merrill Lynch.

Witness Regan: That is correct.

Mr. Moss: I take it sometimes that happens.

Witness Regan: They approach us sometimes. They hear Merrill Lynch is coming to town and they want to join our firm.

Mr. Moss: In that case you take them on?

Witness Regan: We will consider them.

Mr. Moss: <sup>W</sup>ith respect to recruiting and hiring of the branch office, is it done on the branch office level? Let us take Dallas, Texas, again. Would the recruiting and hiring for an office in Dallas be done in Dallas basically?

Witness Regan: There are several ways that we would recruit depending upon the office and the individual circumstances. If this were a brand new office in a brand new town, and we wanted local people, we would probably put a half page ad in the paper. We would then send a team of trained personnel people to the area to screen the applicants. Out of whatever number of applicants there were, and depending upon how many the manager of the office thought he could start off intelligently and keep under control and supervise

properly, that number, about double that number would be suggested to the manager. From the final list selected by personnel, they would go over and select the ultimate number to go to our training school.

Mr. Moss: The manager would make the selection?

Witness Regan: He has the final say.

Mr. Moss: Can he be vetoed in New York?

Witness Regan: Definitely.

Mr. Moss: By the personnel officer?

Witness Regan: Well, not directly. They would talk about it. They would counsel the office manager that they did not think so and so measured up, that he might look at somebody else instead.

Mr. Moss: I take it if a dispute arose, hypothetically, between the branch manager and the personnel man, it would be decided by the president?

Witness Regan: It would probably come to me first.

Mr. Moss: Can you tell us generally what your criteria for selection of account executive is and whether you recruit in any other way than advertising?

Witness Regan: Yes. The whole idea of how we select and the like, I have to give you a bit of background in order to bring you up to date on the reasons why we do as we do.

When we started this training school in 1945,

we had a management consultant firm which by the way is the same one that the New York Stock Exchange used to get their new training program under way.

Back in 1945, we had them set up job specifications and job standards for our account executives. That runs to eight pages, the job specifications of an account executive. I have copies if you want to see it.

Basically what we do in this selection, we are looking for men of good stable backgrounds, highest of moral caliber, men who have drives that would be desirable in our type of business, and men who show a keen sense of stewardship, because in the ultimate they are going to be handling other people's interests.

The Presiding Officer: What are those drives that are appropriate for somebody to be handling other people's business, Mr. Regan?

Witness Regan: I think you would have to get at honesty and integrity. Particularly in finance he would have to have a good numerical facility, things of that nature. You would have to find that since this person is not to have too much analytical techniques that he should not be too much of a student. He should be more of an extrovert, since he is dealing with people, things of that nature. As I say, they run to eight pages.

The Presiding Officer: At the outset you talked

about one of your principles as being putting the customer's interest first. I would like to apply that at the salesman's level. You want a salesman to follow your principles, presumably. I would like to know just what that means at the salesman's level, as you see it. Another witness has said that he considered the standard of professionalism to be putting the customer's interest first consistent with earning a living in a capitalistic system. I am trying to apply this at the salesman's level. To what extent do you indoctrinate and to what extent do you expect that salesmen put the customers' interest first? Is that an actuality or an aspiration or what is it in your firm?

Witness Regan: It is a many sided question.

The Presiding Officer: Yes.

Witness Regan: Let us deal with the first part of the customer's interest. We absolutely insist on that. There are other things we will probably get into later, but I will mention briefly in passing here.

The system on which we compensate men is geared to make certain that the customer's interest comes first. He has no specific interest in the customer's commissions as generated.

Secondly, in all of the principles that we teach our men we are trying to teach them that what is good for one customer is not necessarily good for the other. He must

recognize the difference in objectives of people. Some people need income. Other people want long term growth. Some people do want to speculate and we see nothing wrong with speculating but it must be done with the person's full knowledge of what the person's investment objectives are, and what he is trying to accomplish. It makes no sense for a man to try to advocate that a person with one investment objective buy something else. This is not in the customer's interest. This is what we do not want. That is what we constantly are watching for.

As far as your professionalism is concerned, I would say the professionalism goes a little bit further than the definition that you quoted to me. I would say that first of all if you go back, what were the four basic professions in the Middle Ages, teaching, that is the doctor of philosophy, there was the lawyer, the ministry and medicine. Those were the four. All of those, I think, have an implication of learning, training, dedication, career type of work. I think that is the first thing you think of when you think of professionals within our industry -- a dedicated man, a well trained man, a man of highest intellect, a man of highest caliber, morally -- then the man who puts the customer's interest first.

The Presiding Officer: You feel that your system of compensation is such that it is likely to encourage putting

the customer's interest first and not to simply encourage the drive for selling for the sake of selling?

Witness Regan: That is correct.

The Presiding Officer: Proceed, please.

Mr. Moss: You told us basically how you recruit. Tell me how many people stay with the firm. What is your turnover rate generally?

Witness Regan: As I said in my opening statement, among account executives, exclusive of retirements and deaths, our annual turnover rate is less than 5 per cent.

Mr. Moss: That means --

Witness Regan: Out of 2,000 account executives, less than a hundred would leave us in any one year.

Mr. Moss: Generally why do they leave?

Witness Regan: Most people think to go to competitors. Strangely enough only 7 per cent of those who leave us go to competitors.

Mr. Moss: Of five per cent who leave, only 7 per cent remain in the securities business?

Witness Regan: No, not remain in the securities business, but go to competitors. Some will remain in other aspects of the security business. They may become investment advisors. They may go to work for a bank. They may go to work for one of the large charitable or educational institutions handling their portfolio. They may go to

insurance companies working in there or handling their portfolios. Things of that nature.

Mr. Moss: Would you consider going with a competitor if a salesman went to a non-member firm?

Witness Regan: Yes.

Mr. Moss: You stated that one of the principal attributes of your professional account executive was his training.

Witness Regan: Yes.

Mr. Moss: Can you tell me briefly what the nature or describe briefly the nature of the training program that Merrill Lynch uses?

Witness Regan: We have two types of training programs. The first which I will describe is the regular account executive training program which is designed for younger men. The one I am speaking of first is the one designed for people of age brackets of 24 to 35. These men --

Mr. Moss: They are the younger men, I take it.

Witness Regan: No, they are the older men. The younger men are 21 to 24. It does seem ridiculous, doesn't it. The men who are selected for the regular training program start work in a branch office. Normally the branch office for which they are ultimately designed to work. They are given a 13 week on the job training. There is a kit of material that stands about so high (indicating). That is sent to the office manager

to use in the training of these men on a week by week basis.

There are examinations during this period to see how well he is doing, how well he is acquiring both his on the job training, and how well he is absorbing his reading material.

At the end of the 13 week period, he goes to New York to our training school. He then spends 14 weeks in class room work from 9 to 5 each day, plus several hours of home work. Upon the completion of the training school in New York he returns to his office. He spends another four weeks to eight weeks in a refresher course, office procedures and the like, before he starts handling accounts. Do you want to know about the junior executive program?

By Mr. Moss:

Q During all this time is the salesman permitted to sell any security at all?

A No, absolutely not.

Q As I add up your program, it is 13 weeks in the branch office, 14 weeks in the classroom, is that correct?

A That is correct.

Q That is 27 weeks. Another month?

A A minimum of a month. It might possibly go to two.

Q During that post training can he sell at all?

A Legally he can sell, but he is not permitted to by our organization.

Q I take it the formal training period, the set period of 27 weeks is a minimum requirement for the New York Stock Exchange, is that correct?

A That is right.

Q Do you think that is sufficient?

A Yes.

Q Can you give us generally a brief idea as to what the content of the training program is in the home office, the classroom training?

A Yes. It basically consists of nine to five each day. The sessions normally last about an hour and a quarter. Total we figure is around 430 hours of classroom work. Just giving you a rough indication, incorporation finance, money markets, interpretation of financial statements, the student would spend about 40 sessions. In accounting, income tax, things of that nature, he would probably spend about another 16. On the Securities Act, laws of the securities business, rules of the New York Stock Exchange and the like, he would spend about 30 sessions. Then of course our own things he would have to learn, such as margins, computing, order writing and the like, he would spend another 20 or more sessions. He gets a course in sales technique, a course in effective speaking, a course in speed reading as well as other things such as commodities, underwritings and so on.

Q Do they have any time spent on sales training?

A Yes.

Q About how much?

A The course in the sales and the like lasts about 24 sessions.

The Presiding Officer: Where do you fit in these obligations to put customers first?

Witness Regan: In the 30 hours in rules, regulations, principles, our own policies. I personally give two sessions. Mr. McCarthy gives one and Mr. Leness gives two.

By Mr. Moss:

Q Do you know whether any firms give less than this, any member firms?

A Less training than this?

Q Yes.

A The basic requirement is that you must have six months in business before you are eligible to take the New York Stock Exchange examination. What the other firms do with the person during the six months training period, I do not know.

The Presiding Officer: In other words, there is no New York Stock Exchange requirement that there be training equivalent to what you have just described. There is a requirement that selling is restricted for a period of six months.

Witness Regan: That is correct. The New York

Stock Exchange have recently come out with a new training guide and a trainer's manual which was written by Merrill Lynch, as a matter of fact our own director of training wrote it for the New York Stock Exchange. They have recently held a conference on this to describe it to other member firms.

By Mr. Moss:

Q Now, about how many people do you train in this program each year?

A Currently about 300.

Q That is over a year period, is that right?

A Yes.

Q And of those 300, most of them go on to work for Merrill Lynch as account executives, is that correct?

A In the particular course that I refer to, the regular account executive training program, yes. In the junior executive training program, some do not go into sales.

Q When you talk about a five per cent turnover, you are including the people who begin as trainees?

A That is correct.

Q So there is no large dropout after the training program?

A No. The amazing thing is that in the 17 years of this school, we have put 2100 people through that school. 75 per cent are still with us. This constantly amazes industry that we have been able to keep that retention rate.

Q Do you pay them a salary while they are going through training?

A Very definitely.

Q Thinking about professions, most professional people when they get their training have to pay for it themselves. Why do you think --

A I have heard some law firms say differently. To be serious for a minute, we feel if we are going to attract the type of person that we want, we would say that we have to pay them a decent salary in order to attract the type of person we want. Our minimum salary is \$375 permonth. It can go as high as \$700 a month. In addition to which they get an allowance, \$75 for bachelors, \$150 for a married man while in New York.

Q I take it your answer in substance is that if you did not pay them, it would be very difficult to get trainees, is that right?

A Of the caliber we want, yes.

Q Can you tell me generally about how many present account executives went through this rigorous training program?

A Approximately 67 per cent of the account executives now with us went through the training program.

Q And the other 33 per cent had some lesser degree of training?

A Yes. You must remember among those 33 per cent still with us are men in our 50 year club, lots of men in our 25 year club, and the like.

Q I take it your junior executive training program lasts a year and a half or two years?

A 21 months.

Q Does that mean that the person in the 21 to 24 year age bracket takes this course and doesn't sell for 21 months?

A That is correct.

Q And may never sell?

A And may never sell. He may go into our underwriting department or some other department within the firm.

Q I take it the recruiting is done from college graduates?

A This is college campus recruiting. We send our own recruiters to about 35 or 40 college campuses.

Q Do you have any minimum educational standards for account executives generally?

A Let us put it this way. We want college graduates. About 5 per cent of the people we accept we waive that requirement though they have all attended college.

Q You are familiar with the New York Stock Exchange limited registration examination?

A Yes.

Q Does Merrill Lynch encourage their personnel to

take that examination?

A No, we do not.

Q You allow them to take it?

A No, we do not.

Q So there are no limited registration employees at Merrill Lynch?

A There is none.

Q What is the sales assistant?

A A sales assistant is a registered person who assists an account executive in handling his business. It is usually a she. She will normally take telephone calls for him, give quotes, keep his books of record. In his absence talk to his clients, and answer such questions as she is able.

Q Are they registered?

A Quite a few of them are registered. We prefer to try to register them if possible on the off chance that they might handle an order. They are supposed to be registered.

Q I take it they do not solicit business.

A They do not solicit business.

Q Do they advise customers on securities if the account executive does not happen to be present?

A No, they are only supposed to give actual facts.

Q Which come to them from where?

A From our research material, that is, if somebody says, "What is the dividend on U. S. Steel" or something of

that nature, or what is the market currently doing, normally that is the type of inquiry they would handle.

Q If a customer calls and says, "Do you think I should buy XYZ stock", what is her answer going to be?

A If the account executive that she is assisting is not available to answer this person's inquiry, she is allowed to say to him, "I see by our such and such," -- either our Stock Comment or Security Industry Survey -- "that our firm thinks of it as such and such."

Q Do they get any training whatsoever?

A Yes.

Q Not the full account executive.

A No. They take most of the correspondence courses.

Q Do you see any purpose or use for limited registration? Do you have any opinion on that subject?

A We don't see any purpose as far as Merrill Lynch is concerned.

Q How about other firms?

A I suppose that is their problem. We do not use it.

Q As a leader in the industry do you have any danger in having limited registration people selling mutual funds and MIP's?

A Yes.

Q Can you elaborate, please, if you care to?

A Let us put it this way. We will go back to what I

was talking to the Presiding Officer about, which is the quality of professionalism. We think that people representing a firm, talking to people about their investments, this is a pretty ticklish subject. This requires a degree of professionalism. Normally the limited registration does not indicate the quality of professionalism that might be needed to advise many people about their finances.

Q Let us turn to supervision and control of branch office activities.

The Presiding Officer: I think at this point we will take a ten minute recess.

(Short recess.)

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The Presiding Officer: The hearing will be in order.

Mr. Moss: At the recess we had commenced some questions about supervision. Now, is it safe to say that the first line of defense of your firm with respect to supervision and control lies with the branch manager?

Witness Regan: That is correct.

Mr. Moss: Can you state briefly how they are trained or advised by your firm in connection with their duties as branch managers?

Witness Regan: Yes. Our branch managers are normally selected for the smaller offices from the ranks of our account executives. We normally start looking for a man with eight to ten years' experience as an account executive. All the time he is an account executive, we are constantly getting reports on him. I suppose I could liken these to the fitness reports that the armed forces have. These are turned in by the managers on their people, and each year when the manager submits that report to which I referred to earlier, a report of his operations for the year, he comments on his own staff.

As our people from the home office go out to visit offices, they are told to look at particular individuals within the office to see his capabilities. Having, let us say, a list of those whom we might consider for office

managers, a group of senior officers in the home office sits down and select the particular group that we want to put through this manager-training program. The man, once he is selected -- incidentally, this man sometimes takes a pay cut in order to become an office manager -- he comes to New York for a period, their average has been about one year in New York.

While there, they visit all of our departments. They spend time in the departments. They go out and make extended visits to offices to see how other managers are doing and to report back to us what is going on in those offices. So, by the time they take over as office manager, they have had, oh, ten years or more of training within our firm.

When we come to the larger offices, we select those managers from among the more capable smaller office managers, normally.

By Mr. Moss:

Q Can you tell me who is under the branch manager in his branch office?

A His righthand man is his operations manager. The operations manager, who has been previously trained in Mr. Thomson's division, is in charge of all of the clerical people, the cashiers, the margin clerks, the wire order people, people of that nature in the office. This man has overall

supervision of the bookkeeping in the offices. He is noting various things which he constantly reports back to the manager.

In larger offices there may be a trader in the office who would handle unlisted trading as we discussed previously. Then the account executives in the office come directly under the manager.

Q Part of the supervisory function over the account executive is in some way delegated to the operations manager, and he is looking at accounts and checking books and watching the cashier, is that correct?

A Yes.

Q But the ultimate responsibility is in the branch manager?

A Correct.

Q Do all Merrill Lynch offices have operations managers?

A Every one, yes.

Q Do they have assistant managers?

A We have such a title in Merrill Lynch, but as a matter of practice we seldom use it.

Q What happens if the branch manager is out?

A One of the senior account executives is appointed to act as manager pro tem.

Q He has been chosen because he has shown by his training and by his performance that he could act in that

position in an emergency?

A He is capable of handling it.

Q Who has decided that?

A Normally the manager has talked to New York about who he would designate during his vacation period or something of that nature. If there is no one in the office that is capable -- let us suppose we are talking about one of these newer offices that were just opened, something of that nature -- we would send a person from New York to pinch-hit.

Q Can you describe, and I think you have described some of the duties, briefly, the duties of the office manager?

A Yes. I have such a list here. First of all, he is to train and maintain his staff. He is to put into effect our policies and procedures, interpret and explain them for the benefit of his people. He is supposed to be familiar with the rules and regulations under which we operate and he is responsible for the compliance with those rules.

He approves the opening of each new account. We warn him to exercise due diligence in opening those accounts.

Q When you say due diligence in opening the accounts, what do you mean?

A To learn the essential facts about the new account. We have a new account form with the person's name and address, his occupation. We want credit references. We want the person carefully checked out so that we know, first of all,

with whom we are doing business, and secondly, the manager wants to know what type of account is being opened in his office.

Q The due diligence is due diligence to protect the firm in opening a new account, is that correct?

A Yes. And to see that there is compliance with the New York Stock Exchange rules. I am talking there about making sure the person is not under 21. We are not permitted to deal with minors and so forth.

Q That is to protect the firm?

A Yes.

Q Do you ever conceive of due diligence in terms of suitability? That the manager should know what type of person and what his economic status is in order to supervise the account executive in determining whether his sales and the stocks he represents to customers are suitable or not suitable for that particular customer?

A Yes. At the same time that we open the account, we have a form which we call a 4-R. That form lists on it again much of the same information as the new account form, name, address, occupation, and all that. It also lists the customer's objectives and the service requirements for that particular account.

The manager reviews these each six months together with his account executives. On that same form is a list of

all purchases and sales made in that account. If a person is looking for income, the manager, being experienced in the business, can quickly glance at that account and he can determine whether or not that person has income stocks or growth stocks which might not be appropriate.

Q Does your customer form or application blank contain a statement of his assets?

A Yes. We insist upon knowing the net worth of our clients. In the event that the information is not forthcoming from the office, we make a credit check on that customer.

Q Do you have information with respect to his income generally?

A Yes.

Q I take it your testimony is that these inquiries serve a twofold purpose. First, to protect the company against the customer, and second to protect the customer with respect to suitability of securities which he purchases?

A That is correct.

Q About how many accounts are in the average office, or is that possible to say?

A That is hard to generalize.

Q Give us a range.

A A range? I would say -- may I consult with my people here to see if we can come up with an answer?

The Presiding Officer: Yes.

Witness Regan: It is bugging us on what is the average office.

By Mr. Moss:

Q Let us try it this way. Approximately how many accounts would you have in one of your larger offices, or largest office? Do you have as many as 10,000 accounts?

A More than 10,000. I am thinking back to my experience as manager of the Philadelphia Office. I would judge at that time we must have had about 25,000 accounts.

Q How often is the manager supposed to review these accounts?

A Every six months.

Q Is it feasible, is it reasonable --

A You must remember that he does not do 25,000 at once. This is a continuous process. The average account, a few transactions, a customer buys securities. I am not trying to sound, how will I put it, as though I am trying to talk you down. You must remember first of all a great many people use a broker. They are not interested in what the broker thinks of what they are buying or what their investment objective is. They merely want the broker to act as agent and buy the securities they want. They think they know the market, and the like.

Obviously this type of account the manager does not have to scrutinize, where the man is using him strictly

as a broker.

Others are institutional accounts. You probably automatically do not have to look at the institutional accounts. The same thing for fiduciary accounts where this is an estate being settled or a trustee buying for his trust. Things of that nature, you would not have to look at those from the point of view of investment objectives.

Then you have to get down to the hard core of accounts which the manager definitely has to check.

Q How does a manager know, when he looks at this piece of paper with numbers on it, how does the manager know whether this particular customer is just using you as an agent, never asking for your advice and never consulting with the account executive other than merely to relay the order? How does the branch manager know when he looks at an account, that this requires surveillance, checking and care?

A On that code 4-R it states the investment objectives and service requirements. When the account is first opened and the account executive would note, "Only wants us to execute orders," or he would put, "This man just wants execution," something of that nature, no investment objective, does not want our advice, we don't mail him any of our literature because those come under service requirements. That would be an indication to the manager of what type of account he is looking at.

Q If the customer has indicated that he is not expecting advice but merely executions, does that mean that the account executive is prohibited from recommending something?

A Not prohibited. He might talk to that customer. But normally speaking, such an account doesn't welcome suggestions. Therefore, rather than lose the account by trying to foist opinion, you just refrain from discussion. You merely say, "Yes, sir," and take his order.

Q Would the branch manager ever know whether a particular series of transactions resulted from recommendations or from the customer's own orders?

A In our more active accounts, again at the end of a six months' period after the account has been reviewed, our managers are supposed to either call or write a letter to these clients. First of all, from the point of view of sales, thanking them for the business they have given us. Secondly, inquiring whether the service they are receiving from Merrill Lynch meets their objectives.

In the absence of a negative reply, we would assume that everything was correct.

Q As I understand it, the manager is really relying on the account executive to tell him what the objectives of the customer are in terms of whether he wants Merrill Lynch to be merely an agent or adviser?

A Yes. But you must remember that the account

executive also wants this in writing for his sales assistant to note in the event of his absence, so he has that information right there so it can be turned to quickly when the customer calls.

Q Aside from reviewing accounts, and the function of the branch manager in the six-month review, are there any other controls on the branch office?

A Yes. Each manager receives through our electronic data processing facilities each day a list of trades that took place in the previous day in his office. These are broken down by customer. The office manager goes through these regularly to see or to look for concentrations of particular stocks being bought in his office, to see, frankly, how much activity was in his office.

This is then turned over to the operations department to make absolutely sure that these were the orders that were executed in that branch office on a previous day. That is called the 1028 form at Merrill Lynch.

Q So, as I understand, the next day, on Wednesday, 5,000 orders were executed on bought business and sells. On Thursday morning the branch manager has in his hand a profile of each transaction that took place in his office?

A Exactly. Today's transactions. Take right here in our Washington office, a copy would be given to the Washington manager and in the morning he will have it on his

desk.

Q I take it he is supposed to exercise his general supervisory functions when looking at that piece of paper?

A Yes. That becomes one of his regular duties every morning. Also spots date trading and things of that nature.

Q Does he get a weekly tally?

A No. He also gets, in addition to that, a 1031 form which is a business sheet. This shows all entries in a customer's account, dividends credited, rights credited, it shows withdrawals from the account, plus the purchases and sales. At the end of the month, he gets a summary of all that has transpired in his accounts. He gets an activity report. The activity report shows the number of transactions by account for the particular month, plus the total commissions that have been given to Merrill Lynch.

Q Leaving the branch for a minute, what controls, or what does the home office see with respect to the branch's activities, and what is it looking for? What is your division, which effectively is supervisory, the division looking for and what does it do and what tools does it have available to it in terms of supervising the activities of the account executives?

A Again thanks to these electronic machines, we, too, get a daily list of the 1028 for all offices. We are looking for concentrations and concentrations by offices. An office

can only see purchases of stock from his particular office. From the point of view of the overall firm, we can see purchases in many offices of the same particular stock. We note activity. These are summarized and a report of unusual activity in accounts is furnished on a monthly basis to my division to look over to spot any unusual transactions.

The operations division under Mr. Thomson checks constantly to see that our penny stock policy is being adhered to.

Q What do you mean by that?

A We will not handle orders in penny stocks which we use as a term for stocks selling under two dollars a share. We do not solicit them. We do not want to handle them. That includes Regulation A filings.

Q Let us talk about the Regulation A filings. What does that mean? That Merrill Lynch will not, either as agency or principal basis, execute an order for a customer on the buy or sell side of the Regulation A?

A Unless or until that particular security has maturity and we take two years to see if it has matured.

Q Was that always your policy, that it had to mature?

A The two years?

Q Yes.

A We use that as a rule of thumb. We have had some that grow up to be big companies, and obviously it would be

stupid to refuse to handle orders in that list of companies.

Q Do you have a list of maturing Regulation A's?

A I don't think we -- we will handle it this way. If such an order comes in, and normally these Regulation A stocks are handled in the over-the-counter market, and the trader who is handling the stock and spots that it is a Regulation A filing, or he recalls or sees it is a new name and recalls it is a Regulation A filing, it will be bounced back to the office. If it is over two years, the manager of the office may make an appeal to the head of our trading department and request that, on an exceptional basis, this customer be permitted to buy that stock through us.

Q I now turn to Operations Manual, Section 6-A, Account Executive Functions. On page 107(b) you talk about domestic low-price speculative stocks issued under Regulation A, on the Regulation A filing, that should be amended to say issued under Regulation A filing which have not matured.

There is no prohibition against selling Regulation A offerings. I am a little confused.

A No. We make no provision in the Operations Manual for that. This is a rule experience has taught us. Take a stock you may be familiar with, Control Data, that came out as a Reg A filing. It is a well known and recognized company today. In a strict adherence of our operations manual, you

would not handle shares of that particular stock; but a loose construction, you would.

Q But if a Regulation A offering did not reach that or did not mature to the point where it was a recognized company with a good market, I take it it would still be restricted or prohibited?

A That is correct.

Q When you talk about Regulation A, would you quickly tell us what a Regulation A offering is and enlighten all of us?

A A Regulation A filing is an issue that is issued under the Securities Act of 1933, an exemption of an issue which does not exceed 300,000 dollars.

Q By exemption, would that be exemption from filing a full registration statement with the Commission making all of the disclosures necessary under the 1933 Act?

A Thank you, yes, that is correct.

Q The Reg A would be exempt from making those disclosures?

A Yes.

Q Do your runs, or your IBM runs, in any way highlight or pinpoint over-trading or churning in accounts?

A This activity report to which I referred earlier, wherein each month the manager of the office, as well as certain departments in the home office, is furnished with a

copy by account number the number of transactions in an account and the total amount of commissions. This is summarized also monthly so that there is a cumulative total as well as the individual amounts during the month. This gives the manager a pretty good idea of activity within his accounts.

The normal manager goes down that list. He sees increasing activity in an account, an account that gave \$50 in one month has given \$750 suddenly. He will want to know why. He looks up that account and discusses with the account executive and finds out why the activity.

Q Will the manager call the customer to find out if the account executive's explanation is reasonable?

A Very definitely, he should.

Q With respect to this area, does Merrill Lynch permit its salesmen to have discretionary accounts?

A Absolutely no discretionary accounts allowed at Merrill Lynch.

Q You know that many firms permit salesmen to have, or account executives to have, discretionary accounts?

A Yes.

Q Why does Merrill Lynch prohibit discretionary accounts?

A There is too much danger and too much trouble in an account executive, registered representative, handling an account on a discretionary basis.

The Presiding Officer: Danger to the customer or danger to the firm?

Witness Regan: Danger to both. Danger to the customer and danger to the firm.

By Mr. Moss:

Q Would you say that allowing salesmen to have discretionary accounts magnifies or multiplies the number of supervisory problems the firm has at that point?

A Very definitely.

Q Is it a fact that the New York Stock Exchange has a rule which requires discretionary accounts be supervised directly by partners?

A That is correct.

Q Can any officers of your firm have discretionary accounts?

A Absolutely not.

Q I take it you have no investment advisory clients?

A We have none.

Q So the only advice you give your salesmen, or your account executives give to customers is the normal advice that a salesman gives with respect to purchases or sales of securities, is that correct?

A May I elaborate a little bit? We do have a portfolio correspondence department within our research division. This research division is made up of some close to

300 people. Over half of them are engaged in portfolio work. Based upon, and we actually advertise this as a service to individuals -- if you will tell us all the facts about yourself, we will tell you what our ideas are in accordance with your investment objectives, what your securities portfolio should look like.

We also advocate for the person who had his portfolio reviewed by us do so regularly on a six months' basis. This is not mandatory. It is purely voluntary on the part of the customer, at no charge.

Q You mentioned two policies that your firm has, which I take it are designed to prevent complications of one sort or another, and that is the penny stock policy. You also mentioned the Regulation A policy, both being prohibitions against any type of orders to buy or sell. Are there any other prohibitions or policies designed to protect the customer as well as your firm?

A Among securities that we cannot handle, obviously, the SEC Canadian restricted list to which we add names ourselves. We have prohibitions, of course, on soliciting orders in securities that are under registration. As far as prohibiting customers --

Q You said soliciting orders. Supposing the customer calls in, can you take an order?

A An indication of interest, not an order.

Q You can take an indication of interest. Your rule is that the account executive cannot solicit?

A That is correct.

Q With respect to penny stocks, Reg A, and Canadian restricted list of securities, it goes further than that. They cannot solicit, but they cannot take an order?

A That is right. That also applies to intrastate orders.

Q Why not?

A The possibility that they will leak out of the state and you might engage in a distribution unwittingly.

Q You mean a distribution in violation of Section 5?

A That is correct.

Q That would be an illegal distribution?

A Correct.

Q Is this one of the reasons you don't handle Reg A?

A No. We don't care for them. There is not information on a Reg A for the customer to make up his mind or for us to make up our mind on quality.

The Presiding Officer: Do your rules on penny stocks apply to listed penny stocks?

Witness Regan: We will accept unsolicited orders on Benguet Mining and stocks of that nature which sell for less than two dollars a share on the New York Stock Exchange. Let me put it again. Again a loose construction, we will

accept orders on regional exchanges for stock selling less than two dollars a share, if in sufficient amount. We will not open an account for that purpose and definitely we will not allow our men to solicit orders.

The Presiding Officer: There are some exceptions to unsolicited orders for the penny stock?

Witness Regan: Where listed on a major exchange, yes, sir.

By Mr. Moss:

Q I just want to get one other thing clear. With respect to these prohibitions, can these prohibitions be avoided or exceptions made if an officer like yourself says, passes on it?

A Yes. But the exceptions are few. The actual exceptions to the penny stock policy are granted by the manager of the marketing department. If he has any doubts, he consults with the legal department.

Q Let us take the Canadian restricted.

A No exceptions on that.

Q Intrastate offerings?

A No exceptions.

Q I see also from your manual that another prohibition area relates to securities which we believe are being unscrupulously promoted, which we think are being distributed in violation of U. S. or state securities laws or which

appear on the SEC restricted list. What do you mean by unscrupulously promoted?

A If we had an indication either from our clients from whom we get quite a bit of information, or from the SEC itself in some of its releases, that there might be a promotion going on in a particular stock, the boiler-room technique, something of that nature, we definitely will not handle orders for it.

Q Do you also expect limited application of your account executives and branch managers, they will always be alert in their regions for what could be considered unscrupulously promoted securities?

A We hope they are, and we ask that they pass that information on to us so we can notify other offices either in the area or nationwide.

Q Do you have a recommended list? Does Merrill Lynch have a recommended list of securities in any sense, or a master list?

A Since our earliest days we have had what the salesmen loosely refer to as "The Bible." This is a breakdown. First of all, it gives Merrill Lynch outlook on business conditions, and secondly on the market. Third, it breaks down industries on a page by page basis, and in each industry we select certain securities for various objectives, long-term growth, income, and the like. From those selections

we do make up a master list in varying investment objectives.

Q Is there any prohibition with respect to the activities of employees in their own accounts?

A Oh, very definitely. First of all, this daily trade list that I told you about has all employee trades for the particular office, and again on a firm-wide basis, grouped through a series of numbers. They are all in the same number series. So you can spot at a glance exactly what is happening in employees' and officers' accounts.

First of all, we will not permit our employees to have margin accounts. We insist that they pay within four days even under Regulation T, they might have seven days in which to pay. As I mentioned in my opening statement, as one of our basic policies, we will not allow any employee or officer or members of their family to purchase securities on a new issue when we have customers' orders unfilled.

Q Tell me, with respect to sources of customers, how do your account executives get clients or customers?

A man comes out of a training school or a new branch office is opened, how do they secure customers?

A When they first start out, it is mainly through leads furnished from our advertising. As you know, we have a rather substantial advertising program. We spent over \$3 million last year in advertising. This does bring us in leads. As a result, when a person writes into Merrill

Lynch and says they would like to have some help or information about securities, the person is contacted after the information is furnished to him by one of the newer salesman. Later, as the man matures, as he acquires more accounts, referrals, satisfied customers, become his number one source of clients.

Q Are cold telephone calls a source of accounts?

A No.

Q Not at all?

A I would doubt that any Merrill Lynch account executive would just go to a phone book and start calling.

Q I have here a memorandum dated November 3, 1960, under the signature of M. S. Boyce.

A Milton Boyce.

Q And it is to offices, office managers, and account executives, and the topic is "Cold Calls." Would these cold calls refer to personal calls?

A They would refer more to personal.

Q They don't include telephone calls?

A They might include telephone calls, but in my experience few men make cold telephone calls.

Q Do you think there is something wrong with making cold telephone calls?

A Nothing wrong with them from the point of view of legality or ethics, but wrong from a sales point of view.

Q Why?

A It is very difficult to hear a voice on the phone and have that person convinced of anything.

Q Do you see cold telephone calls as a source of supervisory problems?

A No.

Q Is one of the functions of a manager or supervisor to determine that his salesmen are not making misrepresentations or statements that would reflect badly on the firm?

A That is correct.

Q How would he check on this with respect to telephone calls?

A Obviously he can't tap the telephone. This is illegal. The only way he can do it, frankly, is by looking at the type of securities purchased in his office. The list has a well known list of stocks that are being bought in the office, the new accounts that are opening, buying quality securities. He must assume that there has been no misrepresentation. If all of a sudden out of the blue, there is a peculiar stock, he should investigate and find out why.

Q Should he call the customer, if necessary?

A Yes.

Q Now, just to clear up this telephone solicitation question, I take it from your testimony that although you might not be in favor, there are no existing prohibitions

against cold telephone calls or telephone calls of any nature by Merrill Lynch.

A That is correct.

Q Do you have a policy which requires account executives to mark orders as to whether they are solicited or unsolicited?

A Yes.

Q Is that done all the time?

A Yes.

Not on every order. There are certain securities orders for which it must be marked unsolicited. Other securities which must be marked solicited.

Q When do you have to make these notations?

A For example, on the penny stock. Suppose somebody will sell a penny stock through us, the order is marked unsolicited. Mutual funds we mark unsolicited, other orders of that nature. An order for an issue that has come out but is still under prospectus, we would mark unsolicited.

Q Let me ask this. If there is a speculative stock which does not fall within the prohibitions, do you require the salesman to state on his order form whether he solicited the transaction or whether it was an agency transaction?

A We do not require that.

The Presiding Officer: As a matter of definition, does the firm, or do the salesmen have any difficulty with

the word "solicited" or the word "unsolicited" as applied to particular sets of facts, Mr. Regan?

Witness Regan: I think that has been one of our lawyer's difficulty, trying to define the word "solicited." Our rule of thumb that we try to drum in: Who spoke first? If we spoke first, it is solicited. If the customer brought it first, it probably can be considered unsolicited.

The Presiding Officer: Spoke first about the particular security?

Witness Regan: Yes, who brought it up. That is just a rule of thumb. That is not a legal definition, obviously.

By Mr. Moss:

Q Just to pursue this one step further, what would happen there if a customer called and said, "I was thinking of buying 100 shares of XYZ stock," and the salesman said, "I think you ought to buy 500." Is there a solicitation? Is there any breakdown in the solicitation and unsolicitation question question there?

A May I ask my counsel?

The Presiding Officer: I think the question is not intended to be essentially a legal question, although it might be helpful to get your counsel's version of that. I think the real question involved here is whether, in a policy requiring marking as solicited or unsolicited, this is

an automatic thing or whether it involves a great deal of administration and interpretation.

Witness Regan: No, not as we run it. It is supposed to be automatic. Nothing is left to chance. If it is a Reg A or penny stock, they must put on unsolicited, and they are not allowed to make up their own minds or try to define the subject themselves.

By Mr. Moss:

Q I understand that Merrill Lynch has a policy concerning its officers being directors of corporations.

A That is correct.

Q Can you state what that is?

A Yes. We have felt since the start of Merrill Lynch that our officers should devote their time to our firm. There possibly, and I emphasize the word possibly, could be a conflict between a man being an officer of our firm and a director of another firm without the securities industry, naturally. Accordingly, we have thought in our best interests and in the interests of our customers that our officers should not take any more outside directorships. I state it to you that way because you will find we do have two officers of Merrill Lynch who are directors, one of each in separate corporations.

Q Do you see a conflict in Merrill Lynch, or one of the problems, in Merrill Lynch making a trading market and

having an officer sitting as a director?

A That could be a problem.

Q Was that one of the reasons?

A That is one of them.

Q Would the same be true with respect to underwriter?

A That could lead to problems, too, yes.

The Presiding Officer: Do you ever have an underwriting handled by Merrill Lynch where it becomes desirable or the suggestion is made on one side or another, because you have handled the underwriting you ought to get on board?

Witness Regan: That has been suggested. In the case of Schering, the alien property custodian, where we acted as major underwriter, it was suggested that Merrill Lynch put a man on the board. In this case we passed. We did suggest someone else to go on the board.

The Presiding Officer: You still did not put one of your own men on it?

Witness Regan: No, sir, we did not.

By Mr. Moss:

Q Now, Mr. Regan, towards the end of your opening statement you referred to occasional lapses in performance in your firm, and I take it, supervisory problems, and the firm then takes action.

A Yes.

Q In that connection, I would like to draw your

attention to your California offices and a security called Aqua-Filter.

A Yes.

Q I wonder, first, if you would care to describe as fully as you wish the problems which came up with respect to Aqua-Filter and all that your firm did and all that happened in connection with sales of Aqua-Filter stock in the spring of 1961?

A Yes. This is an isolated transaction or series of transactions which took place in the Los Angeles area in the spring of 1961, April to be exactly.

Briefly, the background is this. The Aqua-Filter Corporation had decided to promote the sales of its product rather heavily within the Los Angeles area. They had taken full-page ads. They had taken radio-TV time, counter displays. The Aqua-Filter is actually a filter for cigarettes to take out tars, nicotine and other harmful ingredients. With the activity of a promotional nature as far as the product was concerned, market interest was stimulated in this particular stock.

The financial pages of the Los Angeles Mirror, I believe, carried quite a writeup by a financial writer on the Aqua-Filter Corporation and its outlook. This triggered the interest of one of our account executives in the Los Angeles area. He called the company to try to find out more

information about it. He was told that the president of the corporation or certain officials were going to entertain members of the financial community at a cocktail party at a hotel in Los Angeles that very day, would he care to attend. He said he would like to attend.

After that meeting was over, at which the outlook for Aqua-Filter had been glowingly described, he returned to his office and started calling clients of ours, accounts he handled, who he knew had an interest in speculative situations.

The Presiding Officer: Excuse me, Mr. Regan. Was there outstanding publicly traded stock at this time?

Witness Regan: There was outstanding public stock in the Aqua-Filter Corporation.

The Presiding Officer: Which was not a pending distribution? It was an outstanding stock?

Witness Regan: That is correct. It was traded over the counter.

The Presiding Officer: Go ahead.

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Witness Regan: He solicited the orders from these clients of his. There were two other account executives in the office who heard his descriptions of this company, asked him about it, and he passed on to them the same information he had heard from the officials of the company. They, too, called a few of their clients. Nothing further happened. The market price of the stock then was about five to six dollars a share. In July, I think it was of 1961, we received a routine inquiry, I believe from the New York office, of the SEC, asking as they periodically do for all odd trades in a particular security. We furnished them with a list of our trades in Aquafilter. Later in August of 1961 they came back to us for more information.

As we looked into this to supply the information to the SEC, this came to the attention of us rather bluntly in the home office that this was an unusual transaction or series of transactions. So I sent Mr. Walker twice to the Los Angeles area to investigate what had transpired, and what had gone on.

In October, I think, we had a complaint from a customer. That was the first and only complaint we had in this situation. Incidentally, I might add that the manager of the office that was particularly involved here died in November of malignant tumor, and he had been in and out of the office at that particular time. It was rather difficult to keep our records straight.

Anyhow, in December, looking over the whole situation, we made a business decision that Merrill Lynch would offer to make good the losses of the customer. By that time the stock was below one dollar a share. We made the offer to our customers. The majority accepted. I might say all of them accepted. We then proceeded to discipline our salesmen who had participated in solicitation of orders in this particular company. We slapped them with fines ranging up to \$2,000 a piece. We reprimanded the manager of the office involved, and then notified the New York Stock Exchange what had gone on.

Subsequently we instituted proceedings to make certain that this type of situation didn't happen again. It was reasonably successful. We got inquiries from our Paris and Rome offices for Aquafilter about a month later. This we immediately stopped before orders were ever executed, reported it to the New York Stock Exchange, and through them the regional office of the SEC, and subsequently the SEC put out a statement to the public and to brokers to be careful of solicitations in Aquafilter.

By Mr. Moss:

Q Have you got anything more to say about Aquafilter at this time?

A That is enough.

Q I might have a couple of questions to tie this down

By Mr. Moss:

Q Did you learn at any time what the financial condition of this company was?

A Did I learn?

Q Yes.

A I subsequently learned what the financial condition of the company is, yes, sir.

Q Is it accurate to say that for the year 1960 the company lost some \$700,000?

A I am not too familiar with those figures. I don't have their balance sheet with me. But I do know they had lost money.

Q Did it come to your attention that they owned no plants of their own?

A Yes, this has come to my attention now.

Q Did it also come to your attention that these securities, that the filter itself had been promoted unsuccessfully in the east in preceding years?

A I don't know as much about that as you may. I am not familiar with that.

Q From your testimony, I gather that about the early spring of 1961, product ad appeared in the local newspapers, there was a general publicity campaign. An article, I take it a very bullish article, appeared in the Los Angeles Mirror?

A That is correct.

Q And there was a cocktail party?

A That is correct.

Q And those are the four situations that occurred which apparently caused great interest in the stock.

A Yes, that cocktail party was attended by representatives, I don't know, maybe 10, 12, 14 different member firms.

Q To the best of your understanding, the president of the company called the cocktail party and primarily to invite registered representatives or members of firms in the Los Angeles area, is that right?

A I don't know that to be a fact. All I know is what our man has told us, that he was told there was a cocktail party in the area and he attended.

Q Let me ask you this. In your experience it is usual for presidents of corporations to have cocktail parties and invite salesmen to them and describe their products, their company in glowing terms?

A There have been and there are quite public relations, if you will, campaigns on the part of many corporations, for good reasons, to which members of the financial industry are invited. Maybe after those cocktails are served, yes. Security analyst meetings and things of that nature, too.

The Presiding Officer: Who would normally get invited, the people in the research department or the selling

end, or both?

Witness Regan: Yes. Normally people in the research division attend for us.

By Mr. Moss:

Q Does Los Angeles have a research office?

A They do not.

Q Merrill Lynch does not have any research activities in Los Angeles?

A No. It is covered from New York. Our electronics man spends most of his time out there.

Q Did you know how many shares of Aquafilter Merrill Lynch sold during the period February 1, 1961 through May 15, 1961?

A Again without being contentious, what do you mean by sold? We acted solely as agent. We did not act as principal.

Q I understand that.

A You mean sold for clients or did we buy for clients?

Q How many shares did clients of Merrill Lynch purchase through Merrill Lynch?

A 97,000; not all of these were solicited.

Q Do you know how many were solicited?

A Not exactly. My guess would be in the area of around 60,000.

Q 60,000 were unsolicited. In the investigation --

let me ask you this, rather. You described the surveillance procedures in the New York office and how the runs come up every day.

A Yes.

Q As I understand this security was a Regulation A security.

A That is correct.

Q Had it gotten to the point where you would consider that it was a mature Regulation A security?

A Let us face it. This is one in which we goofed. This is where we took vigorous action, i.e., making our customers whole and fining our men. This did slip through our first and second line of defenses.

Q Your procedures now or your procedures even then if they were operating fully would have caught this?

A This would never have happened.

Q And you would have stopped it as soon as the orders came through.

A Right, and it will never happen again.

Q This is the type of security you would want to prevent.

A Very definitely.

The Presiding Officer: Your procedures goofed at several places, apparently. I am curious about the relationship of research to this. Would your research department ever get involved in looking at a situation like

this or would it be routine for a situation like this to be solicited by your salesmen without the research department ever knowing anything about it?

Witness Regan: No, that is one of our firm policies that our men violated, and why we fined them. They did not check this security out with our research division. Had that preventive step been taken our research division would never have approved this stock for solicitation and would have given the background information so necessary to make the decision for these men who had solicited orders. That is the policy they violated as well as the Regulation A policy that they violated.

The Presiding Officer: I notice this is in the spring of 1961, and we seem to have come to some other instances involving the spring of 1961. What is peculiar about the spring of 1961, Mr. Regan?

Witness Regan: There was certainly a surge of volume and a surge of speculative fever or feeling in the security market during the spring of 1961.

The Presiding Officer: This might have been the background for this particular incident which your firm did not manage to control in this instance.

Witness Regan: That is how it slipped through, frankly. People were busy. I don't want to cast reflection but curiously enough, the second man who is supposed to

have caught this in the home office, that is, the assistant manager of our trading department is also dead from a tumor. Both of these people, the local office manager and the man in New York should have caught it. Why they did not, we don't know. We can only assume it was because of the press of activities and the like that it slipped through on them. That is what we were horrified to find out in the fall of 1961.

The Presiding Officer: It was the press of activities that perhaps kept them from catching up with the incident, but it was apparently the speculative situation which the salesman out there was adding to or working within.

Witness Regan: That is correct. If you put this in perspective as we reported over the counter questionnaire we handled 2.4 billion dollars of securities over the counter in the year 1961. This involved several hundred thousand dollars. So that it was that type of transaction that slipped through.

By Mr. Moss:

Q Now, with respect to continuing with what the Presiding Officer was saying, would you say that your own salesmen or account executives were not following your warning with respect to investors which says investigate before you invest. Possibly if your salesmen followed that warning, this would not have happened.

A That is why we fined them.

Q In your statement of facts you related to a particular office in Los Angeles and to a particular salesman. I take it in that, purchases through Merrill Lynch of Aquafilter stock took place in a number of offices?

A About four or five offices as I recall were involved. There were 82 customers solicited that actually bought securities. More than half, though, in the one office and more than half of what was in the office by the one man. He was, I would call it, the focal point.

Q As I understand it, what stimulated him were the four things we enumerated but it was capped off by this cocktail party.

A That is correct.

Q He read the article in the Los Angeles Mirror and he had seen ads and the like. Do you know whether he had any financial information or any information other than what he had seen and heard that we have described.

A What he had was what the financial writer of the Los Angeles Mirror had furnished in his article plus the statements of the president about the financial condition of the company at the meeting.

Q Let me ask you this: Express your feeling on this. Would you say that the public expects when Merrill Lynch representative s recommend a security that this is more or less the company's reputation also backs the recommendation.

The Presiding Officer: By the company, you mean Merrill Lynch.

Mr. Moss: Yes.

Witness Regan: I believe our customers would feel that way, yes.

By Mr. Moss:

Q You would not approve at this time of a salesman on the basis of the information he had recommending a speculative security like this?

A Good lord, no.

Q In the course of your investigation or at any other time, did you learn what representations were made to the customer?

A I am speaking here from about third or fourth hand information. I understand the SEC has subsequently taken depositions from clients not only of our firm, but other member firms in the area. I don't know what the customers themselves have told the SEC. This report has not come out as yet. I would imagine the representations were on the basis that this was a good speculation if the man did have a filter that would remove tars, nicoines and other damaging things in view of the many cancer scares and the way the tobacco stocks perform. This indeed could be a good speculation.

Q With respect to representations to persons to

whom it would be sold, would this type of security be considered suitable for almost any investor or for a very small number of investors or for no investors? In terms of suitability assuming it was not a Regulation A stock, and there was no prohibition, would there be suitability limits for a security of this kind?

A We would never recommend it as a speculation to anyone. I would not say this was a suitable stock for any speculative customers of Merrill Lynch that I know of.

Q And certainly people who were not speculative customers, it would be more unsuitable.

A Definitely. It would not be recommended.

Q At this point I would like to read into the record some of the affidavits which we have collected in the course of our study or which the SEC has collected, concerning representations made by three of the salesmen of Merrill Lynch at the Pasadena office. I will use initials rather than names at this time. This is T.R., being duly sworn, deposes and says:

"My name is T. R., and I reside at El Monte, California. I am employed by the R. C. Corporation as a sheet metal draftsman. I have been buying stock through Merrill Lynch, Pierce, Fenner and Smith, Incorporated, since October 1960. During that time I have dealt solely with Mr. J. T.

"I would also like to state that when I first opened my account with Mr T. of the Merrill Lynch Pierce , Fenner and Smith's Pasadena office, I did so with the idea that I was to invest in growth securities which would provide for my son's college education. I told Mr. T. about my plan."

I take it certainly in a case like that this would not be the stock to recommend.

A No.

Q "Approximately April 18, 1961, Mr. T. called me at my office concerning Aquafilter Corporation. He told me that he had purchased Aquafilter stock and so had a number of his friends. He recommended the stock to me. He told me that the company's plant at Shelton, Connecticut, was scrambling to keep up with orders."

I think Mr. Regan has testified that the company didn't have a plant.

"He said that the current production was 300,000 units per day but that by June it would be doubled to 600,000 units, and then doubled again to 1,200,000 units by October.

"He said they were opening a new plant in Gardena or Torrance, and that with this new plant in operation Aquafilter daily production should be hitting 2,500,000 units.

"He said this plant would provide 30,000 square feet of floor space and would employ 150 people. He also stated that this plant would be in operation within five months. Mr. T. said that the net profits by June would be about \$75,000 per month, and should reach \$200,000 per month by September. He predicted that the stock would reach \$10 per share by October 1961. He also told me the stock would be listed either on a West Coast exchange or on the American Exchange."

With respect to those last representations, I take it all of those would not be allowed to be made by account executives on any stock?

A No, I would say these are probably things he is quoting from what he heard at the meeting.

Q Let me ask you this question. To your knowledge did Mr. R.T. even go to that meeting?

A No, he did not. He heard about it from the man who did attend the meeting.

Q If there is no objection I will eliminate the rest of this affidavit which follows consistently except for the last paragraph, which states:

"Upon Mr. T's advice I purchased a hundred shares of Aquafilter stock at \$6 per share on April 21, 1961. The loss that I suffered in this security was made up by Merrill Lynch, Pierce, Fenner and Smith."

The Presiding Officer: Mr. Regan, Mr. Moss, I take it, is reading from an affidavit that refers to one of your salesmen and his customer. I suppose you are not in a position to particularly confirm or deny that those representations were made as set forth in the affidavit?

Witness Regan: No, sir, I am not, nor do I know who took the affidavit. I imagine this is from the SEC regular staff.

The Presiding Officer: If after this proceeding you have any further information you care to supply on this incident, we would be glad to include it in the record.

Witness Regan: Thank you, sir.

Mr. Moss: Also, if as a result of Mr. Walker's investigation or any investigation the firm took there is any information you care to state with respect to statements that customers gave you or statements which related what the account executives told the customers, we would be happy to have them now or at any time.

By Mr. Moss:

Q I would like to read one or two others. This is a short one.

"NLF being duly sworn deposes and says:

I reside at Pasadena, California. I am an officer in the United States Navy stationed at Pasadena. I have been dealing with Merrill Lynch, Pierce, Fennar and Smith

for ten years on the East Coast, and later in California.

"Mr. L.A. has been my customer's representative for about two months in Merrill Lynch's Pasadena office.

"On April 19, 1961, at approximately nine p.m., Mr. A. called me at home and said he had come from a meeting sponsored by Aquafilter, and that he was informed that the company had just put its product out in Los Angeles. He also stated Aquafilter looked very good and that Aquafilter's production could not keep up with the demand for it.

"Mr. A. also stated that the filters had not been offered for sale in the east as yet since they could not supply the local demand, but when they did one could expect a very interesting future. This was my first experience where a registered representative of Merrill Lynch had phoned me at home.

"I asked Mr. A. what the stock was selling for and he said it was either six or six fifty per share. As a result of the above conversation I purchased a hundred shares of stock at 6-3/4 per share on April 20, 1961. Previous to my purchase I had not been told about the financial condition of this company. Had I known, I would not have purchased this stock. I did not consider it necessary to question the recommendation made by one of Merrill Lynch's registered representatives.

"Shortly after I purchased the stock it went down three points or so. I called Mr. A, who said it was caused by some adverse publicity put out by someone in the east who had sold several thousand shares short and wanted to depress the stock, but this was temporary and I could expect the stock to recover."

"In January 1962 Merrill Lynch offered to make good my loss which I accepted."

Now, in the course of the investigation, were there any conversations with customers of the Pasadena office or anywhere else?

The Presiding Officer: In the course of whose investigation?

Mr. Moss: Merrill Lynch's investigation.

Witness Regan: In the course of our investigation?

By Mr. Moss:

Q Yes.

A The acting manager of the office and the manager that we sent out to replace the manager who had died did talk to our clients, yes.

Q You I think generally stated what Merrill Lynch did. Can you tell us when the first step was taken and what you did?

A The first step was to make the customer whole. That was our first step.

Q I mean in terms of discovering that this was a practice that was not usual.

A We secured the information which the SEC had asked for, a list of trades. That was our first step.

Q That was your first notification that there were any problems in connection with customers?

A That was not a notification. This was a routine inquiry which we receive regularly from the SEC.

Q Can you tell me how many of your salesmen were disciplined?

A Eight.

Q Eight were disciplined.

A Yes.

Q Were they all in the Pasadena office?

A Three in the Pasadena office, and the others scattered among three other offices.

Q What was the general nature of the discipline?

A Fines.

Q Any suspensions?

A No, fines and reprimand noted on their record.

Q Can you tell us what the largest fine was?

A \$2,000 was the largest fine and it ranged down to \$500.

Q As a result of activities of salesmen or as the result of the discipline you meted out to the salesmen, did any

salesmen leave?

A Yes, one did. He thought the fine was too stiff for the crime.

Q Let me ask you this. When he was terminated did you file an RE-4 form with the New York Stock Exchange?

A Yes.

Q Do you recall what you stated on the RE-4 form as the reason for termination with respect to the record of the individual?

A He resigned from our firm. He was not terminated by us.

Q Was there any disclosure to the New York Stock Exchange of this salesman's activities?

A We described the entire incident to the New York Stock Exchange after we had taken our steps. Then they subsequently investigated also to find out what was going on.

Q So that the New York Stock Exchange was fully apprised of this man's participation before he left the firm?

A Definitely.

Q When you say you made restitution --

A I didn't say we made restitution. I am being legalistic.

Q When you gave the customers or when you made the customers whole.

A Yes.

Q On what basis did you do that? All customers?

A All customers who were solicited. If there was a gray area, whether it was solicited or unsolicited, we leaned over backwards.

Q Did you contact the customer to find this out?

A Yes. The managers of the offices contacted the customers personally.

Q Let me ask you this. If I had been a purchaser of Aquafilter in April 1960 at a price of \$6.50 and in August I sold it for \$1.50, would I come within the number of people who would be offered to be made whole?

A Yes.

The Presiding Officer: Mr. Moss, much more, or will you finish?

MR. MOSS: I think I can finish this in ten minutes.

The Presiding Officer: Proceed.

By Mr. Moss:

Q Was there a manager in the Pasadena office in April 1961?

A Yes.

Q Was he on duty at that time?

A Yes, he was. He had been in the hospital for a brain operation, recovered from the brain operation. We had been advised by his doctors that he was fit for duty and he had returned to duty.

Q I take it a lot of this activity took place in the evening.

A Yes, as I said describing this, it took place after the meeting at the cocktail party.

Q Do you know whether the manager was present when all this took place?

A No, he was not.

Q The next day there were also substantial purchases?

A That is correct.

Q Did he handle the problem in any way?

A No, not to my knowledge.

Q Let me ask you this. Mr. Cohen referred to the speculative fever which hit the public in April 1961. I would like to know what your feeling is what the function of a firm like Merrill Lynch is in a situation like that.

A Surprising enough in view of what we have been talking about in the past few minutes, Merrill Lynch had become more concerned at that particular time about what was going on in the market. We issued -- I can tell you several ads. I will just read you the titles so you can see what we are talking about.

In March 1961, all prices subject to change in which we described that the markets just don't go up. Let's start at the beginning.

"Wall Street One Way? Don't believe it. Wall Street is not a one way street. It never was and never will be."

Then we had a rather large ad, called "A Matter of Some Concern". This was in May of 1961 in which we said "We are concerned about the number of people who have been buying stocks in recent months for what we believe are the wrong reasons, wrong for them. These are people unsophisticated who buy securities, often victimized by tips and rumors." In other words, people were speculating imprudently. That is the type of thing we were saying to the public.

To our own customers we were concerned about the market in our Market Opinions and the type of stock we were selecting.

Q Did you distribute this feeling to your own managers and account executives?

A Definitely.

Q Can you tell me whether other large brokerage firms were selling this stock in quantity in California at this time?

A To my own knowledge I cannot testify, but I can say I understand this was so.

Q You referred to a New York Stock Exchange investigation. When was that commenced?

A January 1962.

Q Do you know what the nature of the investigation was?

A I do know they sent investigators out there who talked to our people as well as to other houses of the area.

Q Do you know what they were looking for? Were they looking for violations of their rules, of NASD rules?

A They did not tell us what they were looking for. They were merely investigators.

The Presiding Officer: Mr. Regan, did I understand you to testify earlier this morning that your personnel is not compensated in proportion to production of business? That is not an incentive or motivation for selling or for any derogation from professional attitudes and so on.

Witness Regan: That is substantially correct. May I tell you about our compensation policy?

The Presiding Officer: Yes, I wish you would.

Witness Regan: Our salesmen are paid on a salary basis. Twice a year we give them adjusted compensation if their performance is surpassing what we normally expected when we set their salary. You might say is this a bonus, is this a commission arrangement. No, because the adjusted compensation that we give them, we take many factors into consideration.

First of all, how well the customer is doing. Secondly, how many errors have they had. Third, what is the quality of their work. Fourth, have they been any trouble to

the manager, and the like, before we determine what they should be paid from then on.

In addition, of course, all of our people participate in our very large benefit program. We have a cash bonus for all employees, including salesmen, at the end of the year. We have a deferred profit sharing which I think has \$30 million of assets at this point. We have a pension plan. All of these salesmen are included in them. We have quite a generous insurance program for them. So his compensation is not just in terms of being on a commission basis.

The Presiding Officer: It is a salary basis, but with these semi-annual provisions which take into account performance including production of business.

Witness Regan: That is correct.

The Presiding Officer: I don't want to overwork the Aquafilter situation, but I suppose the sales that were made in that or any other security would be a plus factor, but the various errors and problems that were involved would be a minus factor in your scale of compensation.

Witness Regan: Yes, very definitely. In fact, the amounts of money that we returned to the clients were charged against the offices and against the AE's production.

By Mr. Moss:

Q I would like to ask a couple of questions about

mutual funds and your views on them.

A Yes.

Q It is our understanding that Merrill Lynch does not solicit orders for the customers purchasing of open end mutual funds, is that correct?

A That is correct.

Q Open end investment companies. Can you tell us what the policy of Merrill Lynch and what it is based on and why do you not feel that your firm should solicit mutual funds?

A Yes. I think that we can characterize this mainly as a business decision that originated back in 1940 when the firm was first put together. At that time, you realize that mutual funds were not the factor or not as large as they are today. In deciding what the new firm, the merged firms would do, in the way of business, you recall they were going over new policies, new this and that and everything else. The decision was made that they would not handle mutual funds. We concentrated on listed business, unlisted business, underwritings, bonds, commodities and the like. That decision was made and we stuck to it. Over the years our attention has been devoted to that. At the present time we see no big demand on the part of our customers for this particular service. We think we have sufficient services through the use of our research division for the use of our clients. Accordingly, we just have not gone into the business.

Q There is nothing particular about the sales of mutual funds that would not be consistent with Merrill Lynch policies or Merrill Lynch training. It is just a business decision not to encumber your organization with the sale of mutual funds.

A That is a broad generality. I would say yes.

Q Does Merrill Lynch get much portfolio business from funds?

A We get some, but not much.

Q Would you say, considering the size of your firm, it was smaller than you would expect?

A I don't know that we would expect, because Merrill Lynch expects to do all the business. It is very small in relation to our normal business.

Q About how much in mutual fund sales do you do in terms of unsolicited purchases?

A Last year about \$400,000.

Q Do you sell or does Merrill Lynch execute orders for no load and closed end funds?

A Yes.

Q More so than open end funds?

A Honestly I have never broken the figures down.

Q Your compensation schedule with respect to sales has been covered. How do you pay managers?

A Managers. About 55 out of our 60 offices are

managed by vice presidents. These men are paid on a national salary basis as determined by a salary committee in the home office, the same as my salary, Mr. Thomson's or anybody else. The remainder of the managers are paid on a salary basis, and once a year they receive adjusted compensation based again upon many factors. How well their office is doing, the number of errors in the office, their control over expenses, whether or not their office is growing in size or declining, quality of the people that they have, things of that nature.

Q You said earlier that a manager may take a cut to take a manager's job.

A I said an account executive may take a cut.

Q That is what I mean. How would that happen?

A There are many account executives in Merrill Lynch -- let me put it to you this way. 62 per cent of Merrill Lynch account executives earned more than \$15,000 and some earned into six figures. The average compensation of a Merrill Lynch manager last year was \$34,000. Obviously if it is one of our largest producers who decides to become a manager and gets what the average manager is getting, he would have a reduction in salary.

Mr. Moss: I have no further questions at this time.

The Presiding Officer: You have referred a couple of times to errors.

Witness Regan: Yes, sir.

The Presiding Officer: That is a term I am familiar with in other fields, but not in connection with the securities business. What do you mean by errors?

Witness Regan: Unlike the baseball field there are things that really cost us money. Errors -- let us state that our customers have numbers we use for our electronic bookkeeping. It is an eight digit number. Suppose the last five are 12345, and the account executive transposed those figures and it ended up 12435. Two customers would be notified or would be disappointed by our action. One would be told that he bought a security that he had not ordered, and the other would be told that he had not been bought a security that he wished. This costs quite a bit of money to correct. That is one type of error they will commit, Buying the wrong stock, told to buy General Motors and they write it General Electric.

The Presiding Officer: You are talking about mechanical errors and not errors of judgment.

Witness Regan: That is correct.

The Presiding Officer: I think that is all there is this morning. We thank you, Mr. Regan. We are sorry we didn't hear from Mr. Thomson. We appreciate both of your coming.

(Witnesses excused.)

The Presiding Officer: The hearing will be in recess until 2:15.

(Thereupon at 12:45 p.m., a recess was taken until 2:15 p.m., the same day.)

AFTERNOON SESSION

2:15 P.M.

The Presiding Officer: The hearing will be in order.

Are you ready to proceed, Mr. Paul?

Mr. Paul: Yes, sir.

Mr. Presiding Officer, the first witness for the industry this afternoon will be Shearson, Hammell & Company. The person who will testify will be Mr. M. D. Safanie, directing partner, Mr. Robert C. Van Tuyl, managing partner, and Mr. J. B. Dunbar and R. J. Teweles, partners. They are represented by Mr. Frank Crabill and Mr. Leonard Joseph, of the firm of Dewey, Ballantine, Bushby, Palmer & Wood. Whereupon,

M. D. SAFANIE

ROBERT C. VAN TUYL

J. B. DUNBAR

R. J. TEWELES

were called as witnesses and, having been first duly sworn, were examined and testified as follows:

The Presiding Officer: Gentlemen, it is customary in Commission proceedings to advise all witnesses of their constitutional privilege. Since you are here represented by counsel, I assume your counsel has so advised you, and if in the course of the testimony you have any reason to consult

counsel as to the availability of the privilege, of course, you may be perfectly free to do so.

Proceed.

EXAMINATION

By Mr. Paul:

Q Mr. Safanie, could you state your name, position and address for the record, sir?

A My name is Murray D. Safanie. I am the directing partner of Shearson, Hammell & Company. My address, did you say?

Q Yes.

A Katonah, New York.

Mr. Paul: Mr. Van Tuyl, could you state your name, position, and address for the record?

Witness Van Tuyl: Robert C. Van Tuyl, managing partner, Shearson, Hammell & Company, 14 Wall Street, New York.

Mr. Paul: Mr. Dunbar, would you state your name, position, and address, for the record?

Witness Dunbar: John B. Dunbar, partner, Shearson, Hammell & Company, Los Angeles, California.

Mr. Paul: Mr. Teweles, would you state your name, position, and address, for the record?

Witness Teweles: Richard J. Teweles, partner, Shearson, Hammell & Company, Los Angeles, California.

Mr. Paul: I understand that with respect to the matters of organization, training, and similar matters, Mr. Van Tuyl will be answering the questions. Is this correct?

Witness Safanie: That is correct.

By Mr. Paul:

Q Mr. Van Tuyl, I would like to ask first about the organization and business of Shearson, Hammell. Could you tell us when the firm was organized?

A The firm was founded in 1902 as a member firm of the New York Stock Exchange.

Q Could you tell us what its primary activity is?

A Its primary activity to this day is the execution of business on the New York Stock Exchange and other exchanges of which we are members.

Q This is substantially an Exchange commission house, is this correct?

A Exchange commission business is still the majority of our business, sir. We have important elements of our business transacted elsewhere.

Q Could you tell me, sir, which exchanges the firm is a member of, the principal or national exchanges?

A Yes, sir. We are members of the New York Stock Exchange, American Stock Exchange, the Pacific Coast Stock Exchange, the Midwest Stock Exchange, the Canadian Stock

Exchange. Do you wish a list of the commodity exchanges, sir?

Q I think it is sufficient for our purposes to state you are also a member of the commodities exchanges.

A We are members of nine commodity exchanges.

Q Are you personally a member of the New York Stock Exchange?

A I am not, sir, no.

Q The American Exchange?

A No, sir. I hold my firm's membership in the Pacific Coast Stock Exchange.

Q Are you a member of a special committee?

A I was a member of the Special Committee to Investigate the American Stock Exchange, known popularly as the Levy Committee, yes, sir.

Q Is your firm also a member of the National Association of Securities Dealers?

A We are, sir.

Q I would like to get, if I could, an idea of the size and scope of operations of your firm. Can you tell me how many partners there are in your firm?

A There are presently 27 general partners and 7 limited partners, all of whom are retired general partners.

Q And the number of employees altogether?

A Approximately 1950.

Q How many registered representatives do you have?

A We have approximately 625 people registered with the New York Stock Exchange, of whom only about 570 are engaged in acting as registered representatives. The balance are service personnel, secretaries to partners, order clerks who happen to be in contact with the public, and things of that nature.

Q They are registered simply because they occasionally have contact with the public, but they are not primarily engaged in the sales of securities?

A Precisely.

Q How many branches do you have?

A We have 45 branches in this country and two outside of the continental United States.

Q Could you give us an idea of the geographical range of your branches?

A Yes, sir. There are 9 metropolitan New York City area, 3 up-State New York, 3 in Massachusetts, 4 in Connecticut, 4 in Florida, 3 in Texas, single offices in Illinois, Michigan, Minnesota, 2 in Arizona, 11 in California.

Q So that generally you span the country but in groups. Is that a fair statement?

A That is correct, sir.

Q Do all of these branch offices conduct a general business?

A Yes, sir.

Q Do they largely operate as autonomous units or do they operate generally under the supervision of the home office?

A The office in New York maintains a general policy control and supervision over all branches of the firm. Below the level of top policy and top level supervision in areas of administration and day-to-day supervision, we are decentralized in the respect that the partners in Chicago have certain responsibilities with respect to the Midwestern offices and partners in California have certain responsibilities with respect to Pacific Coast offices. The southwest, the southeast, and the northeast are administered almost completely by New York.

The Presiding Officer: Do you have underwriting originations around the country, or would they be essentially New York?

Witness Van Tuyl: The underwriting department is completely controlled and operated in New York. A piece of business may come to our attention through an office remote from New York, but the processing is complete, and control is complete in New York City.

The Presiding Officer: That would be essentially handled in New York?

Witness Van Tuyl: That is right.

The Presiding Officer: How about trading markets?

Are there separate trading markets in any of the areas or any particular branch offices?

Witness Van Tuyl: Yes. If it is a national market name and we are maintaining a market in the stock, the market is maintained in New York. In addition to that, trading facilities are available in the firm's Chicago Office, Los Angeles Office, San Francisco Office, and to a quite modest extent our Hartford, Connecticut, and Springfield, Massachusetts offices.

The Presiding Officer: The list of securities in the latter offices would be separate and different lists from the main list in New York?

Witness Van Tuyl: Yes, sir. No two offices make a market in the same security.

By Mr. Paul:

Q I wonder, Mr. Van Tuyl, if we could get an idea of the growth of your company. Could you give me an idea of the number of employees that you have altogether, ten years ago? You say you have 1900 now.

A Anticipating that question, Mr. Paul, and by your leave, I took off some figures which are not quite a ten-year figure. I took the first postwar year versus 1961 or 1962 since the growth of this firm has happened largely since World War II.

In 1946 we had 13 general partners and one limited

partner. Today we have 27 and 7, as I indicated. Total employees in 1946 were approximately 275. Today they are 1950. Registered representatives in 1946, 50, in 1962, among those serving as registered representatives, 570.

Q Do you have figures for the same period on the number of branch offices?

A Yes, sir. In 1946 we had 7 branch offices. Today we have 47.

Q So there has been a rapid expansion in the number of branches and the selling personnel in the postwar period?

A Yes, sir. If I may, I would like to digress a little bit on this rate of expansion. I don't think it is totally irrelevant in terms of the additional workload put upon the firm by our growth. In 1946 approximately 20 to 25 per cent of the business which we cleared through the New York Stock Exchange was generated by the branches of Shearson, Hammell & Company. The balance is what we call correspondent business, business which we cleared for other member firms not having offices in New York City.

At that time the percentage of business which we were clearing related to the New York Stock Exchange total reported volume was only slightly less than that which we are presently clearing. The difference has been that today 85 to 90 per cent of the business that we handle and clear is generated by Shearson branches. Only 10 to 15 per cent is

clearance for other member firms. So that the growth picture is not quite as simple as it might appear from just a casual look at the statistics.

Q Do I understand that whereas you formerly conducted a small amount of Shearson, Hammell business and a great deal of business for other non-New York firms, now you handle most of your business for Shearson, Hammell, both New York and outside of New York branches, and very little for others? Is that a fair statement?

A That is correct, sir.

The Presiding Officer: Would you have any comment or explanation, Mr. Van Tuyl, as to what brought about this change that you just described? Is this greater emphasis on your own selling or is it some change in the structure of your offices, or what brought it about?

Witness Van Tuyl: It was part of a deliberate plan on our part to broaden the base of our business. I think it is pertinent, also, to point out in 1946 between 90 and 95 per cent of the firm's revenues were derived from the execution of business on the exchanges throughout the country. The balance might have been over-the-counter. It might have been commodities business, and the other elements of the business.

We were not in the underwriting business at all. We were not in the mutual fund business at all. We made no

secondary markets in common stocks or bonds. It was our concept that if we were to serve the needs of the investors throughout the country over the years to come, we should adopt what, within the family, we have called the department store concept. That is, we should try to make ourselves professionally able to service all the needs of the investors, be it securities listed on the Stock Exchange, bonds, new issues, mutual funds, or anything else that might meet the need of the individual investors. We felt it was wise of the firm to have its own representation throughout the country to enable it to grow and build itself in these various fields.

By Mr. Paul:

Q In the growth that you have been involved in, I have been interested in the Form OTC-3 submitted by the special study which you filled out and supplied us some extensive answers to. I wondered if you could describe generally the growth of the over-the-counter business done by your firm since 1949 in terms of number of shares sold and the value of shares sold?

A I don't happen to have those figures in front of me, but as part and parcel of this program I mentioned, we were not underwriters and made no markets in secondary securities in those days.

In 1949 the over-the-counter volume was largely the execution of agency orders which may or may not have been

solicited. In 1961 we were maintaining markets in common stocks, corporate bonds, municipal bonds, throughout the country. I think it is fair to add, also, that over the years we have developed a certain specialization in our research department looking into the over-the-counter securities and not confining our view necessarily to just that relatively small group of listed securities. Whereas in 1949 our policy was confined to the major companies listed on the exchanges.

We have become managing underwriters, and underwriters, which has given us a live interest in the security market we have underwritten.

Q In 1949, from your questionnaire, it would indicate that you sold an estimated 237,000 shares in the over-the-counter market with an aggregate value of \$5 million, while in 1961 you sold in excess of 18 million of shares with an aggregate value in excess of \$266 million.

Would this largely reflect an equal increase in the number of securities in which you make a market or general growth in volume or a combination, or how would you describe it?

A In 1949 I doubt if we were making a market even by the end of that year in more than a half dozen securities. It was about the time we started. Also, this process evolving from the clearance business to our own business had begun to set in, but had not come to full flower.

Q Can you tell us how many securities you are currently making a market in?

A Pardon me, sir?

Q Could you tell us how many securities you are currently making a market in?

A Nationwide, common stocks, my guess would be something between 60 and 70, sir.

Q Mr. Van Tuyl, as a matter of firm policy, do you have members of your firm as directors on listed companies and over-the-counter companies?

A May I state it the other way? We do not have a policy which prohibits it.

Q Do you have directors of listed companies?

A Yes, we do, sir.

Q Do you have directors in over-the-counter companies?

A Yes, we do, sir.

Q Could you tell approximately how many in each category?

A I would say there are probably about 7 directorships of listed companies and perhaps 8 to 10 directorships of unlisted companies. I can get you the precise information if you like.

Q I think we have some of it in your OTC-3. Could you describe generally the kinds of companies in which you have directorships or the circumstances or reasons which

compel you to have directors in companies, and not to have them?

A I would say the initiative has invariably come from outside the firm. Many Of the cases where we hold directorships, the company has been an investment banking client of the firm and has sought to have access to and the benefit of the advice in financial matters of a principal of our firm. I know of no case where we have taken the initiative and ingratiated ourselves onto a board of directors.

The Presiding Officer: In connection with underwritings, it is not a policy to accept representation on the board of companies, the securities of which you have underwritten?

Witness Van Tuyl: It is not a policy to accept that, no. I know of no cases where we have taken the initiative to ingratiate ourselves. On the contrary, we have turned some down.

By Mr. Paul:

Q Some of the companies in which your firm has directorships, I take it, are firms in which you are making a market?

A There have been those, and there are those, yes.

Q With respect to the organization of Shearson, Hammell, your internal organization I am speaking of, could you describe for me the major divisions within the firm and

their responsibilities?

A I should try, sir. It is not quite as compact an answer as your question might suggest. The partnership in this partnership agreement lets the day-by-day, week-by-week policy control and supervision of the firm stand in the hands of an executive committee of five partners. All of the activities of the firm head up in one way or another to one of those five partners.

There is, for instance, a partner in charge of what we refer to as our institutional department, which includes the entire investment banking functions syndication, institutional coverage, secondary market trading. There is a partner who directs the research and investment advisory activities. There is the senior floor partner who directs all floor activities of the firm. There is our directing partner, who is our firm's chief executive officer, responsible basically for the formulation of policy. I am the remaining member of that committee, responsible for administration.

Those are the major elements of the organization. In each of these areas there are other partners charged with specific responsibilities and reporting to the member of the executive committee. We have no division which is responsible in and of itself for the management of branches. On the contrary, the partner in charge of the institutional department has cognizance with respect to the operation of

the branches in investment banking operation and syndication.

The partners in my end of the business are responsible for the detailed operational administration of the branches. The research partner similarly has direct contact with the branches in the matter of security selection, investment program, portfolio review and the like of that.

Where questions arise as to the propriety of an order, its terms, or the propriety of its execution, that is referred to the floor partners. So it is a functional type of supervision, sir, as opposed to a horizontal kind of organization.

Q If I understand it, then, the branch manager of each branch would be reporting to one of the five members of the executive committee, to one or another of them, with respect to the different activities.

A In actual practice, I think you could say that is correct, Mr. Paul. Additionally, I think, however, it would be fair to say that essentially overall they have a sense of reporting to me as the firm managing partner. On the other hand, they would be referred obviously to another member of the executive committee if it is a matter under his cognizance.

Q With respect to your recruiting and training, which of the five partners on the executive committee have jurisdiction?

A I would say the development of criteria for recruitment and screening and the development of content of our training program comes largely under my jurisdiction in all these areas. However, I consult with my fellow members of the executive committee in matters in which they are more versed than I.

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By Mr. Paul:

Q As to the branches, we have reviewed that. With respect to your hiring policies and the investigation of the individuals hired to serve as registered representatives, could you briefly describe to us the policies which you use and the standards which you use?

A Yes, sir. To the maximum extent that it is practical -- let me first say the source of candidates for employment either as qualified salesmen when they come to us or trainee salesmen to go through our training program, is varied. I would say the most important source is referrals from people within the organization or from persons outside the organization in whom the firm has confidence. There have in some instances been deliberate recruitment programs on the part of our firm.

There are any number, and there have been over the past several years, of persons who for reasons of their own come in to see us and seek employment in this category. If a person has a background and is experienced and is registered and has a clear record with some other organization, especially if it is a member firm of the New York Stock Exchange, if he passes muster in at least two interviews, if his record and previous employment checks out correctly, he is subjected to no formal screening technique. If he has not been in this business before, or if his experience is modest and he seeks therefore to come in as a trainee, the

great majority of such candidates are put through one of two series of screening and aptitude tests.

We have one center which is handled in New York for offices basically in the Midwest and Southwest and Northeast; another in Los Angeles for which we handle it for the important part of the Los Angeles chain. In the case of the Los Angeles group, these screening tests are administered by Psychological Services, Incorporated, and scored by them and appraised by them.

Parenthetically I might note they have been doing this for some ten to twelve years for quite a few member firms in Los Angeles, so it is possible to evaluate the raw score in terms of past experience of the persons in the industry.

If you would like, I can tell you what the basic content of those tests is. It includes screening (all Psychological Services test), verbal comprehension, numerical ability, visual speed and accuracy, verbal reasoning, word fluency. Aptitude: Bruce sales comprehension, Kuder preference record, Guilford-Zimmerman survey of opinion (personality). Minnesota personality inventory. Alport-Vernon-Lindsay motivation.

All of the candidates for training who have not demonstrated an acceptable record in the securities industry before coming to us with few exceptions are required to take

these examinations.

Q What are you looking for through these examinations?

A We are looking, I think, for two things. One is that degree of stability, emotional stability, emotional maturity, if you will, which we think is fundamental and also some achievement in the actual technical skills, the use of language, the ability to reason arithmetically correctly. Other personality traits which when measured against the profile of people who are successful in this business gives you some assurance that the person is proper raw material.

Q The experience of these testing organizations over a period of years with these tests suggested that you can determine a likelihood of emotional stability through them?

A We don't place a 100 per cent reliance on them, no. We use them as important confirmation of our own evaluation of the man. I will say this, that since we have been using them, I think our attrition rate has been lower than it was before we did.

Q Now you say when someone comes in who has a degree of experience in the securities business, you don't require this type of testing and screening?

A No, sir.

Q Do you have any rules of thumb of standards of length of experience, whether the experience must be with stock exchange firms or other firms, how old a person must be

when you are employing persons that you are not giving this testing to.

A I would say we attach much greater weight to a prior successful experience with a stock exchange member firm than we do with similar experience with a non-member firm for the reason that he has had exposure to a broader spectrum of business with the stock exchange member firm in most cases.

Q But you might or might not give the same screening to a candidate from a non-member firm?

A That is right.

Q Do you have any minimum educational requirements?

A Not that we could state for you, sir, in any kind of formula. We certainly prefer to see some concentration in a man's academic life in subjects which are related to this field. I could not state a straightaway minimum educational standard for you.

Q This is all with respect to training. What sort of investigation do you use with respect to the two categories beyond the testing? I understand, of course, that they are subject to investigation by the stock exchange itself. I wondered what independent investigation you made.

A Without exception we check certainly the last employer. If that period of employment seems to be short or is in a field which is totally remote, we may go to a prime employer to get an even better reading of the way the person

fit in the organization, the competency indicated, the reliability which the employer could place upon him and some assessment of the way he measured up to his responsibilities. If a man had been with his prior employer three months, we would go back of that three months period. If he had been there five years, we would content ourselves with one reference as far as the previous employment is concerned.

Q Do you have references other than employment references?

A It used to be that we checked character references. Without trying to be cynical about it, we came to the conclusion that nobody gives a character reference except somebody who is going to speak well of him. We have reservations how important character references are unless it is somebody we happen to know.

Q Do you look outside of given references? Do you go to schools?

A We have on many occasions checked school records, yes, sir. There again especially if a person's business career has been rather short since his graduation from school.

Additionally, anybody that we employ is at the risk, if you will, since it is their option unless we ask it, of a thorough investigation by the bonding company.

Q Do you rely to some extent on the results of the

bondin company and the New York Stock Exchange investigation?

A I would say we view the favorable reaction or favorable results of the New York Stock Exchange examination as very important confirmation in terms of character and past record of anybody that we submit for registration. We don't rely on it in the sense that we abdicate our own responsibilities, but we do think that this is a terribly important confirmation, because we know of the caution and care they exercise.

Q This is a confirmation of an investigation which has been made.

A That is correct. They would not have made it until we proposed a person for registration.

Q Now, if we could go to your training procedures you have supplied us with a volume covering your sales training program. I take it that this program falls into two parts, is that correct, sir, the formal training program and the pre-training program?

A That is right, sir.

Q Could you tell us first about the pre-training program, how long it is, and what it consists of?

A Yes, sir. We endeavor to recruit and have at work in his office of eventual assignment any person who is going to join our training program for two months at least prior to the start of his particular formalized training class.

During that period the prospective trainee is expected to take and pass the New York Institute of Finance course, work of the Stock Exchange and brokerage office procedure. This is designed to give him a beginning working knowledge of how a brokerage office operates, what the basic operations of the exchanges are, how transactions are handled, the effect of federal credit regulations and so forth. It also gives him some insight into what the relationship is as he observes and sees activities within the office between client and between registered representative. He is exposed to the administrative operations of the office, how business is handled over the wire, the kind of publications there are, what the tools of the trade are. So at least he has learned a bit of the language of the business before he reports to us for formal training in New York.

That constitutes briefly -- I might say also that each of our branches has a complete bibliography of additional information, not all of which is mandatory, but titles of various publications which are good for the man to have exposure to. So when he arrives at our training school in New York City we are able to presuppose some minimum level of comprehension as to what the language of the business is, how a branch operates, what its mission in life is, and the like of that.

Q Would you say that as to this pre-formal training

period, this runs from two months to three months?

A It will run from 8 to 11 weeks, sir, yes.

Q Would a substantial part of the time be spent in the studying of the institute courses, or would a very substantial part be spent in observation, or would some part be spent in actual performing of work functions, on the job training sort of function?

A I would say it is a combination of all three. I don't know what I can weight it for you. Certainly it would not take more than half of his time to take the correspondence course. On the other hand, we endeavor when he is taking that part of the course which has to do with the handling of orders to let him spend part of his day in the order department of a branch and see in real life what these pieces of paper are, and how they are processed. By the same token as he is learning about the handling of securities, he is spending time in the branch office cashier cage, seeing the precautions exercised, the diligence used in accepting certificates, the receipt and payment of customers' funds. I could not break it down in percentages for you.

Q When he has finished that program, he comes, I take it, into a formal program. Could you describe that formal program for us in terms of weeks, classes and so forth?

A Yes, sir. The formal program is conducted in New York. The firm has reliance on professors from New York

University in various specialized fields. Various agencies within the industry in New York such as representatives of the odd lot firm, specialists, members of the Exchange, the Exchange staff, and also heavy reliance upon our own competent senior people, partners, department heads, and division managers.

I would like if I may to read into the record the basic subcaptions of the course unless you would prefer to save time.

Q No, I would like to ask you this. You have described in your outline four broad areas. Could you tell us what the broad areas are?

A I don't think I understand the question, Mr. Paul.

Q Does the formal program roughly divide into fundamentals of finance, the operations of the securities business, the rules and regulations of the firm, and the regulatory agencies and development of personal and sales skills?

A Those are all parts of the training course, yes, sir.

Q How long does this formal program last?

A 15 weeks, sir.

Q How many classes are covered in that 16 week period?

A There are about 425 to 430 class hours over and above home assignment work.

Q How long are the classes?

A They are roughly nine to five with lunch time break.

Q So that someone who is studying during this 15 week period is putting in roughly eight hours a day in study plus home work besides.

A I would say it is roughly seven hours a day of lectures, study, observation, departmental assignment and so forth. With home work to boot. There are reading assignments outside the class room sessions.

Q Could you describe some of the courses and the periods they take for us? Corporate finance, for example. How long do you spend on that?

A There are 18 classroom hours devoted to corporate finance. That is one of the courses which is taught by a professor from New York University, I believe. If I may read, sir, from the outline, it is a study of the principal forms of business organizations, their formation, financing, liabilities owners, tax aspects. The owner's role in the corporate structure, comparative study of the instruments employed in raising equity capital and debt financing with emphasis on long term obligations. Sources of funds available to the corporation, especially long term sources. This is just a birds-eye of the content of that course.

Q Did you also give a course in the analysis of financial statements?

A Yes, that is a course of 12 classroom hours, treating with the nature of financial statements, their uses

and limitations. Analysis of balance sheets, profit and loss statements. Sources and uses of funds analyses. Ratio analysis, including balance sheet ratios and profit and loss ratios, per share figures, trend analysis, analysis of industry statements and so forth.

Q Do you also give courses in reading improvement and public speaking?

A Yes, sir, we do.

Q Is this part of the development of personal and sales skills?

A Yes. The reading course stems from what I have always heard a common complaint in the business, that I can't get my reading done. The aggregate of financial publications, daily newspapers, annual reports, proxy statements, prospectuses et al, constitutes a formidable amount of reading which a well informed man should address himself to. We got rather tired of hearing people complain that they could not keep up with it and decided to attack the problem.

In our training program we have a reading improvement course. We have had some gratifying results in terms of improved reading speed along with improved comprehension. We think it has been a useful addition to the personal skills of our trainees.

Q Is this taught by someone from your firm?

A This is taught by our training director. We use

the Harvard reading improvement course, which is a cinematic type of presentation.

Q I gather you also have training involving observation in the course in connection with the exchanges.

A Yes, sir. They visit the various exchanges. They visit a typical odd lot house to get a complete comprehension of the handling of odd lots. They visit the specialist posts and observe the specialist system.

Q Do you also have courses in investment programming?

A Yes, we do, sir. This also is conducted by an outside professor. I might say that in this respect in many of these areas we have reliance on outside help not because we don't have the talent within our organization, but we realize that teaching is an art in itself. We have many people who can do that job, but that does not mean necessarily you can teach. So that we have in certain areas decided to rely on professional pedagogs. The investment programming course which is 24 classroom hours, covers the sources of economic and statistical data, nature of capital interest, the problems of investment, the nature of financial and interest rate risk, purchasing power risk, structure of yield, analysis of individual investment requirements, constructing a security portfolio, its management, investment policies of banks, insurance companies and investment companies.

Q Does this cover your training in research or is that

a separate operation?

A The research training is carried along with this in the respect that presentations are made by analysts from the various industries within our own research department on those techniques of security analysis within a given industry. There are things which the railroad analyst is concerned about and looks for which are peculiar to railroad securities as opposed to oil securities or utilities and so forth. So each of the various analysts will appear before our trainees and review the techniques used within his particular industry, the significance of the results of research and so forth.

Q So your research program is more related to specific industries?

A That is right, sir.

Q You also have a course in sales psychology and techniques?

A Yes, we do. We place a fair bit of emphasis on this because included in this area of our training is a pretty comprehensive treatment of what the function of an RR is in its broadest implications, what his responsibilities are in terms of keeping informed, how he should conduct himself, very candidly how he can learn to cope with people, to understand the points they may raise in a given situation, how to deal with them courteously and effectively.

Q The course covers the functions of a salesman, I

take it.

A Yes, sir.

Q I note from your outline that your first heading is serving customer's best interests. Is this your thrust as related to professionalism in the industry?

A I would say that is my thrust with respect to the twin brother. I have been asked to characterize what I think things are that a firm should stand for. I name them in this sequence deliberately. Integrity, and then professional competence. I say serving the customer's best interests is a question of just plain human integrity. Professionalism gets into the knowledgeability, the acquisition of skills and the proper application of the skills.

Q You say professional integrity and you distinguish professional competence. In your use of the word "professional" are you confining it to the area of competence or do you as I believe many witnesses have embraced within the term professional, the idea or ideas of ethics and integrity?

A I have no quarrel with their doing so, sir. I think as a practical matter a person can be well versed and skilled in the fields of finance and yet not be a person of integrity. A person can be of complete integrity and also completely incompetent. So I suggest that there is room for both characterizations.

The Presiding Officer: Are you saying that your

concept of integrity involves serving the customer's best interests first?

Witness Van Tuyl: Yes, sir.

The Presiding Officer: So you would call that an important concept of your firm?

Witness Van Tuyl: I think it is the single most important concept.

The Presiding Officer: Do you feel that is an existing fact in your firm and in the industry or do you think that is aspiration of the industry?

Witness Van Tuyl: I think like all human aspirations, it is one which we can march close to.

The Presiding Officer: Like the Golden Rule.

Witness Van Tuyl: Precisely.

By Mr. Paul:

Q In the functions of salesmen, you have indicated also it embraced serving self interest and the working tools, techniques of the person who is selling the securities, is this correct?

A Is that what?

Q Is this correct?

A Yes, sir.

Q You also have a course on the NASD and New York Stock Exchange examinations, 15 hours, which reviews examination material, SEC regulations, constitution and rules

of the New York Stock Exchange. I take it this is not the total extent to which the regulatory aspects of the industry are taught?

A No, sir. Instead of having specified, and identified sections having to do with training and education and federal security regulations as a single subject by itself, we have tried in the various things that we do bring up, such as for instance lectures on investment banking and syndicates to bring into the presentation there as a part of the whole picture the applicability of the statutes rather than treating them by themselves. We try to relate them, as I say, to the whole body of material in one element of the business.

Q Could you give us a rough idea, and it will only be very rough, I understand, of the total part that those aspects take in your total training program? Would it be a quarter?

A I don't think it would be a quarter.

Q A tenth?

A I thought out of the roughly 420 classroom hours it might be fair to assume that between 20 and 30 hours concern themselves with this area.

Q As your trainees are engaged in these courses, do they take examinations periodically given by your company?

A Yes, they do, especially with reference to the outside instructors that we have. Each of these courses has an examination which must be successfully passed.

Q Are there any people who flunk out?

A We have had two men whom we have terminated prior to the completion of their training in the training classes that we have had to date.

Q How long is the formal training been going on?

A Since 1960.

Q When do your trainees take the NASD exam?

A I believe in the case of the NASD they take it at the end of their fifth month of training, including the roughly 8 to 11 weeks they had in the pre-indoctrinational training and the period they spend in the classroom training.

Q This runs from eight to eleven weeks and then 15 so that would be 26 weeks or six months. So they take it about a month before the end of the course.

A Precisely.

Q When do they take the New York Stock Exchange examination?

A At the completion of their training.

Q Is there further training which you might describe as post-graduate training?

A Yes. In the respect that our managers are enjoined to pay particular attention to the day by day work habits, correspondence, productivity, qualitatively of what our trainees achieve when they get back to their branches. They are not tossed in with the old pro and considered to be

one of them. On the contrary, special attention is dedicated to the kind of work he does, the kind of things he represents, the kind of statements his customers have at the month end, and so forth. I believe also in many of our offices where there is a significant number of younger men in the business special sales meetings are also held on a weekly basis= for the trainees. This would not be the case where you have one trainee in 15 or 18 man offices.

Q They are now selling.

A They are not registered. Let us not call them trainees. Let us call them the most recent graduates.

Q In fact, your training program runs the exact span of time which is set forth in the stock exchange rules as the minimum length of time.

A It is, sir.

Q How many trainees do you train in a term or a year?

A We try to operate three classes a year, and they are geared to hold 25 or 30 men. There are 27 in the present class.

Q So you may have between 90 and 100 persons a year?

A I would prefer to say 75 to 90.

Q Do you have any persons who are coming to you now as trainees who do not take this formal course?

A We have some in branch training around the system. We are doing our best to diminish, decrease it and hope

eventually eliminate it. We have had some cases where persons who struck us as being completely outstanding candidates because of educational attainments or industry, find it difficult if not impossible for practical personal family reasons to pull themselves away from Minneapolis, Minnesota, and come to New York for 15 or 16 weeks. In those cases we subject them to complete battery of courses available through the Institute of Finance and we also demand closer adherence to the bibliography material which the firm sent out to the branches and more demanding on the provision of time of the manager to work with these men. Our whole emphasis is to diminish in branch training as compared to home office training.

Q You hope except for extremely unusual cases of family problems to have all of your persons take the formal training program.

A That is our objective.

Q How many of your total sales force at present would have gone through this formal training program.

A We only started in 1960, Mr. Paul. To date there are about 75 graduates.

Q Would you say that with respect to those taking the in branch training, their training resembles the present training recommended as such by the New York Stock Exchange?

A As a matter of fact, with the availability of the study guide and the trainer's manual, we shall see to it

that our in branch training conforms as closely as we can and certainly covers the ground covered by that training manual.

Q Didn't your firm have something to do with the training manual?

A Yes, sir, our personnel director worked with the Stock Exchange in the development of both. Mr. Funstan was kind enough to express his appreciation for the contribution he made.

The Presiding Officer: How long has that been in effect?

Witness Van Tuyl: I believe Mr. Funstan sent me a courtesy copy with his letter of thanks dated some time late February or early March. It was labeled advance copy. So the material has been available to the member firms since some time in March of this year.

By Mr. Paul:

Q Now I see from your sales training program in several spots, starting with the history of your firm, the reference to the firm that research built and partnership emphasis on research and research emphasis in various parts of your sales training program. I would like to ask you a little bit about the organization and operations of your research department. Could you give us an idea of its organization and size?

A Mr. Paul, if I may, I would like to defer to my

partner, Mr. Safanie, who happens to be the man who founded our research department in 1926.

Mr. Paul: I would be happy to have Mr. Safanie answer the questions. Could you tell us, sir, how the department is organized?

Witness Safanie: The department is headed by one of the members of the executive committee to which Mr. Van Tuyl referred, Mr. Walter Maynard. He has that department as well as the investment advisory department. In turn, another partner by the name of LaTourette is directly in charge of the operations of the research department as distinguished from the investments advisory department, reporting through Maynard. I cannot tell you precisely, Mr. Van Tuyl can better than I, the exact number of senior security analysts we have but there are quite a good many for the size of our business. They are supported by junior analysts and clerks. I would guess the entire organization consists of at least 50 people, and probably another 12 or 15 in the investment advisory department, who work pretty closely with the research department.

In addition to that we have representation on the research department in strategic important local financial areas such as our Chicago office and Los Angeles, primarily for the local situations on which they would be better qualified to investigate than the New York office and do it more promptly.

I came to the firm -- do you want me to elaborate on my philosophy and the reason for the research department?

Mr. Paul: Yes.

Witness Safanie: I came with the firm in January 1926, 37 years ago, I believe out of an entirely different field. As a matter of fact, I was with the Treasury Department at the time in charge of the investigation of the United States Steel Corporation with respect to its excess profits taxes for the First World War period. I was invited by Mr. Shearson, who was the then senior partner and founder of the firm, to come and have a chat with him, he having heard of me through his former associates in the United States Steel Corporation, of which he was one of the founders, and its first comptroller.

I had no background or experience or knowledge of securities whatever from the standpoint of a securities firm. However, I had considerable amount of experience that I believe in his judgment at least qualified me for objective examination of corporations from the point of view of gaining some knowledge on which you could base recommendations and give ideas to clients. He had the vision and foresight to see a long time ago that the time would come as it indeed had come when the matter of research and knowledge of securities would become an important thing. It was not then. I was not a very popular person as head of the research

department in those early years. However, the department grew in size and stature. Its roots are very deep. We got an early start in the field. It enabled us to establish many relationships and contacts with industry in the early days not only on the basis of drawing information from them but also being sufficiently competent and qualified so that managements sought ideas from us in exchange which is the most satisfactory way to learn what is going on where you can make an equivalent contribution in addition to picking somebody else's brains.

We have continued throughout this period to devote ourselves to focusing our business objectives, our ability to build our business, on this research philosophy. We did it for several reasons. One obviously I suppose I had a prejudiced point of view about the need of knowledge of securities.

Secondly we came to the determination along time ago that the opportunity for growth in this business was limited to a few areas in which you might be able to excel some other firm or competitor. We realized, or at least I felt at the time that in the field of executing an order we might do a fraction better than the next fellow today or worse than he tomorrow.

This is not a basis on which to compete. The area is limited as to how successful you can be or how much better

you can be. In the field of having adequate financial resources this is pretty well prescribed nowadays, thank goodness, by the Exchange and by the Commission. So we cannot say that our capital is adequate and someone else's is inadequate.

As to integrity, obviously we felt everybody should be on an equal basis. It narrowed down to the one area where you had, you might say, to use the vulgar term I like to describe it, a fighting chance to be better than your competitor. That was in the field of research, in the field of producing ideas that will help clients to obtain whatever their objectives might be.

This philosophy has prevailed throughout the firm. It is on that basis that our business has grown and was built up, and it has since been conducted, as I say, not delegated to some junior down the line, but always to seniors. I believe it is perhaps the only firm, certainly the only firm of its size, in which two of their senior partners devote a major part of their time to the field of research and investment advisory work, which is related.

Mr. Paul: So you would say, I take it, sir, that research as a concept and in operation has been a keynote of the growth of your firm?

Witness Safanie: I am sorry, I didn't hear the last.

Mr. Paul: It has been a keynote of the growth of

your firm.

Witness Safanie: Yes.

Mr. Paul: It is also used by you as an affirmative selling point, that is, you encourage your sales personnel to advertise the advantages of your research department, is this correct?

Witness Safanie: Yes, that is correct.

The Presiding Officer: When you refer, Mr. Safanie, to investment advisory activities as related to research, are you there talking about investment counseling in the sense of clients on a fee basis?

Witness Safanie: Yes. It is under the investment advisors act or under the provision of counsellors. We are not supposed to use the term "counsellor". We are registered under the Act, and we charge a fee for the supervision of accounts. We have many accounts which range from insurance companies and labor unions and trusts and so forth on down to businessmen's accounts where capital gain is a primary objective for that kind of operation.

The Presiding Officer: When you refer to your investment advisory activity, you are not merely talking about investment advice incidental to selling of securities. You are talking about a separate service to customers on a fee basis.

Witness Safanie: Yes, sir. As a matter of fact,

clients are not required to transact their orders resulting from a recommendation through our firm. They have the right to do it elsewhere. It is specifically provided.

Mr. Paul: To go back to the organization of your department, sir, I have a chart dated November 1961, which indicates that there are four principal departments or divisions of the department or departments of a division. Securities analysts, portfolio review, library and service staff and trainees. As to the security analysts, there are here listed some 16 senior analysts. Would there be also a number of junior analysts under them?

Witness Safanie: That is my impression, yes.

Mr. Paul: Is that organized by industry so that one analyst specializes in various industries?

Witness Safanie: That is correct. That is the common practice nowadays.

Mr. Paul: You also have a department of portfolio review.

Witness Safanie: Yes.

Mr. Paul: Can you tell me what the operation of that department is?

Witness Safanie: In essence, and I can only give you a rough outline, you understand that I am not active administrative partner -- in essence it is a unit under the supervision or working in coordination with the research

department and the investment advisory department, that takes care of the inquiries which we solicit from our branch offices of reviews of clients' accounts wherever they can be obtained and where the registered representative can obtain them so that we can give advice on the propriety of the makeup of a portfolio. This is solely for the review of portfolios and not individual securities, as distinguished from a portfolio. This is done without a fee.

Mr. Paul: This is without a fee and you offer it as a service to your clients to have their portfolios reviewed on some periodic basis?

Witness Safanie: Yes, sir.

Mr. Paul: And when the local customer, such as Dallas, wants his portfolio reviewed, it is done by this department in the research department?

Witness Safanie: Yes. In order to make as effective as possible portfolio approach or analysis or handling an account, the account is not paying a fee for management, we do an additional thing which may be of interest to you. We make available to our organization quarterly what in effect is a fund of a businessman, a theoretical businessman, that would suggest the composition of securities that we at the time consider to be appropriate for such a person. If you forgive me for taking an additional minute on it, I think you might find it of interest and value.

This was done some 12 years ago in order to get across to our organization those particularly who do not have clients who were clients of the investment advisory department the function which the investment service performs. They in turn could to some degree perform more professionally as investment advisors.

We hit on the idea of publishing regularly or establishing a theoretical fund, a fund which in life did not exist, with \$400,000 of cash available. We said this is going to be a businessman's investment fund. We will show you through the operation of this fund just exactly how we would implement some of the actual ideas of the research department and investment advisory department and reflect them in this fund, and do it so it would not create any possible impression of prejudice or bias in the account it is operated their way.

If today we decide in a committee meeting and we hold committee meetings, investment policy committee meetings, and so forth, that stock A should be sold and B bought or cash retained or what have you, as of the close of the market tomorrow -- we first publish the fact that we made a decision today -- then at the close of the market tomorrow, so there can be no question about the time when the theoretical order was executed, whatever the last price is is assumed to be the price at which this recommendation was effected.

We then further publish a memorandum that it was effective, at what price and how much cash was used, and therefore how a cash balance was either increased or reduced.

In addition to this we charge against the principal of that account the capital gain that would have been payable if it were an individual. We charge it from the principal even though it is deductible from the income tax return or payable out of income as a rule.

We also charge against the fund the theoretical investment advisory fee it would pay if it were a client. We charge this to the principal.

I might add to you that its performance has been excellent. At no time to my knowledge has it had more than 80 per cent of its money in common stock. At no time have there been questionable, risky, hazardous securities beyond those which a businessman would be entitled to take --

The Presiding Officer: Mr. Safanie, are you describing a program for investment advice or what are you describing, what is essentially a promotional tool in selling your invest advisory service?

Witness Safanie: Both. It is done for both purposes. Wherever we can combine two purposes in one, we are happy to do it. It serves as a basis for demonstrating to a potential investment advisory client what our performance might have been through the demonstration of this theoretical

account. More important than that we have used it in recent years to demonstrate to our registered representatives how they might, if they applied good common sense and judgment and used the tools which we make available to them, the ideas we make available, how they might implement these ideas in the accounts over which they have -- which they serve.

The Presiding Officer: At this point we will take a ten minute recess.

(Short recess.)

The Presiding Officer: The hearing will be in order.

Mr. Paul, you may proceed.

Mr. Paul: Mr. Safanie, in connection with your research department, I take it you issue a number of publications of one kind or another.

Witness Safanie: Yes, sir.

Mr. Paul: Among these, I take it, are research bulletins. Could you tell us what the research bulletin is and when it is issued?

Witness Safanie: In essence I don't believe there is any stated period of publication. In essence a research bulletin contains a report or reports on several companies which the research department, if you will, has researched through digging into the facts concerning the company, the industry, its competition, its customers. As usual, and perhaps without exception, I am not too sure about this, but

with very few exceptions in any case after discussion with management and very often also a visit to the company's plants or stores or whatever their properties may be, to get some sense of feel of the facts concerning the company. In summary, I would say a research report is issued as a rule when we find that a certain security of a certain character appears to us to be undervalued in price. The whole effort of research is very largely one of trying to determine whether securities are over priced or underpriced. There is a vast distinction between price and value.

Mr. Paul: Are research bulletins issued with respect to a particular company or an industry?

Witness Safanie: A particular company as a rule. Occasionally we have industry reports where a research report on a company might be preceded by a report on the industry.

Mr. Paul: Are there particular types of companies that you cover or don't cover in these research bulletins? Do you cover speculative issues?

Witness Safanie: I think we would cover the range of companies that have attributes that we are looking for, whether it be an income security on occasion, one that will assure the highest degree of stability of income return, one with some possible assurance of increasing income over a period of time or growth. These in turn would range in quality all the way from perhaps the highest degree of conservatism

or quality to some degree of speculation, yes. We do not turn our noses up at what might be called commonly a speculative security. Speculations, after all, become investments very often.

Mr. Paul: What is the distribution of these research bulletins?

Witness Safanie: They are quite general. We do not have, I don't believe -- Mr. Van Tuyl might want to comment if I am wrong -- we do not have a general distribution list. The distribution is made through segmented mailing lists that are provided by each of our various offices and in turn for each of the registered representatives for their clients as well as for prospective clients. They furnish these lists and we maintain the addressograph plates. There is no regular mailing unless the customer either requests the publication or a registered representative or man places the name on the list.

The Presiding Officer: Do these go out to Correspondent firms?

Witness Safanie: Yes, sir, they do.

The Presiding Officer: And to selected segments of your customer list?

Witness Safanie: Correct, on a selective basis. We have another publication which perhaps Mr. Paul will come to in time which automatically is sent to every client for

whom we mail a statement at the end of a particular month. That is known as Business and Securities. That is a more general discussion of the business outlook and sometimes the security outlook.

The Presiding Officer: On these research bulletins would a typical bulletin cover one company, or would there be brief paragraphs on several different companies? What would they look like?

Witness Safanie: More often it would cover a minimum of two, sometimes perhaps three. Occasionally one single company.

The Presiding Officer: Are they in printed form or mimeographed form?

Witness Van Tuyl: Multilith.

The Presiding Officer: Is it your practice to advertise as to the availability of new bulletins from time to time?

Witness Safanie: On occasion. I think Mr. Van Tuyl can answer that question better than I.

Witness Van Tuyl: Yes, sir. We maintain around the nation some six or seven regular radio programs and we have a program for advertising in other media such as newspapers. Research bulletins and another one of our series of documents called Special Reports are very frequently the particular item which will bring to the attention of the reader or the

listener inviting him to send in for a copy of the report to get a sample of the firm's research output.

To answer your question, Mr. Paul, earlier, we print about 85,000 copies of each edition of the research bulletin.

The Presiding Officer: So that these are distributed to the groups and the firms that you mentioned. They are also available for distribution to those who might answer these advertisements.

Witness Van Tuyl: That is right.

The Presiding Officer: I assume that then becomes a source of potential new buyers for your firm?

Witness Van Tuyl: That is correct, depending on the locality a respondent to that kind of advertising under the direction of a manager is assigned to a registered representative or in the case of our radio advertising in New York, the firm sends the particular document requested to the respondent and invites the respondent to solicit additional information from us by way of analysis of his portfolio or suggestions for the investment of funds. In New York it is only the person who answers the second solicitation that we give to a manager for assignment as a lead.

Mr. Paul: So in brief, these go throughout your organization, and they also go to a selected portion of your customers and they go to a group of potential customers and

they go to other firms.

Witness Van Tuyl: That is right.

Mr. Paul: I am not sure whether I should address questions along this line to Mr. Safanie or Mr. Van Tuyl. There was a reference to special reports. Mr. Safanie, can you tell me in which way these resemble or differ from the regular research bulletins?

Witness Safanie: I think perhaps Mr. Van Tuyl better take that.

Witness Van Tuyl: A special report will invariably be written on a single company. More often than not it represents at least the first time in a long time that the firm will have expressed itself on the company in question. It may be a security which is less well known. It might be possible, for instance, in the course of three quarters of a page to write an intelligent story on the present status of American Telephone Company. Whereas if we have become interested through research and field examination in a company less well known which we have not discussed before we may find it necessary to spend two, three or four pages of text in getting the complete story across. So a special report is merely a more fullsome treatment usually of a single subject or company and frequently one on which we have not expressed ourselves within the recent past.

By Mr. Paul:

Q Is the distribution of the special reports similar to the distribution of the research bulletin?

A I would say perhaps somewhat less, Mr. Paul.

Q You also have a list of advisory and followup bulletins.

A Yes, sir. That is a publication which as its name suggests is designed merely to bring up to date stories we have issued earlier. There may have been a comment in the research bulletin, for instance, of last October, on the United States Steel Corporation. We might for obvious reasons find it desirable to make a followup comment in the month of May about the United States Steel Corporation. Without the need to recapitulate all that has been said before, a brief squib might be sufficient. It would be a rather short story. The advisory followup bulletin would be the mechanism we would use for that purpose.

Q Do you have advisory and followup bulletins with respect to all of those that you issue research bulletins on?

A Not unless we have something to say, sir. In other words, we don't go to a list of past research publications and say we must say something. On the contrary, our men are aware of the body of ideas we have outstanding, and they are charged with the responsibility of keeping the organization currently informed. This is the medium by which they do it.

Q You also have a publication entitled "Business and Securities". Can you describe that one for me?

A Yes, sir. That is a publication which Mr. Maynard, our partner who directs our research activities, tries on a monthly basis to evaluate the business climate. The activities of government, the international situation as may be appropriate, economic indicators, and relate the aggregate effect of these on the outlook for the securities markets. The format of that publication has changed just as of the last issue. We have expanded it to a larger document. In addition to this it now presents a recapitulation of the ideas presented by the research department in the past month. This publication is enclosed with all statements to clients at the month end. So every client of the firm is apprised at least monthly of the firm's assessment of the investment situation as of the close of the month.

Q Does this publication relate to or give opinions with respect to particular securities, or is it simply general in nature?

A The first part of it, and I would say two thirds of it is general in nature. The latter third may well give thumbnail characterizations of the recommendation made or the findings made with respect to securities discussed in publications during the month.

Q I also find a listing of special edition news

letters.

A This is more of an internal document. It is a news letter. It is a medium by which we circulate around the organization information about securities which we don't think is of such importance as to warrant publication in our more formal publications. It will contain, for instance, the reports of the comments made by a corporate official at an analysts meeting. It will contain the particularized research a man may have done in response to an inquiry he has received from the branch office. Things that he might think of fairly wide interest, but not sufficient importance to warrant inclusion in a major publication.

Q Is the distribution of these special edition news letters exclusively within your office?

A There is no prohibition against mailing them out. I would say the distribution outside the office is relatively small compared to research bulletins and special reports and advisory and followup bulletins.

Q There is also a category unlisted securities reports. Can you describe that for us?

A This is merely a special format. It is not unlike a special report, but obviously it will deal with an unlisted security. It is put on its own letterhead which is distinctive in its makeup so there can be no question that we are dealing with an over the counter security and not a security

listed on the national securities exchanges.

Q When you say its own letterhead, it is the firm letterhead but a different format?

A Yes, that is right, with a distinctive color and format.

Q Are there other publications, either general or internal on a more or less regular basis which your research department promulgates?

A There is one very important internal publication which stems from the research department, and that is what we refer to as our master lists. Master lists are a catalog, if you will, of the securities which we are keeping under constant surveillance in which is presented the firm's current opinion upon issuance as to whether we recommend it for purchase at the particular time, or whether it is worth continuing to hold in a portfolio. It is classified both alphabetically and industry and pertinent current statistical data is provided. If between monthly issuances of the list information comes to light or developments take place that cause us to change our opinion in evaluating the security, a wire advice is given to the organization which might read, "The ABC common stock is being changed from a buy to a hold rating". Or "It is being removed from the list. This is our way of focusing simply the attention of the organization on these securities which represent the current recommendation

of the firm's research department.

Q The master list, as I understand it, is published monthly.

A It is published monthly and altered and changed day by day as circumstances warrant.

Q It is updated monthly but amended by wire to your offices in the interim.

A Precisely.

The Presiding Officer: Mr. Van Tuyl, the other day mention was made of over the counter securities. Mr. Bache expressed the view that it would be desirable if over the counter securities had available I think he said semiannual earnings in the same manner as listed securities. Do you have any comment on the desirability of information as to over the counter securities as compared to the listed securities?

Witness Van Tuyl: We have some very strong convictions on it, Mr. Presiding Officer. We would be glad to comment in formally. We have a statement we will leave with you which summarizes our firm's views in the area which I am testifying on. This is one subject which we have mentioned in our memorandum. We certainly agree with Mr. Bache that public disclosure of current operating information on the part of unlisted companies is a highly necessary and desirable thing. I am not sure about fixing the period at twice a year. Perhaps it should be quarterly as in the case with listed

companies. Certainly when a company becomes publicly held at some point in time the public is entitled to current information with respect to its operations.

The Presiding Officer: Thank you.

By Mr. Paul:

Q With respect to your master list -- strike that. I would like to get into the master list in some more detail. Are there other special lists of special types that you distribute from time to time?

A We have two or three master lists in that group. There is a second masterlist which represents situations that have come to the attention of responsible members of the firm on which some clarifying statement has been made. We also operate a short term trading list. These are situations where the individual who is interested in short term trading can get the benefit of our ideas on opportunities that may exist in that area. They are suggestions that arise from technical considerations, market considerations, as well as considerations of value.

Q I have in your folder a list, not for distribution, memo to all registered representatives, dated November 1961, dealing with the electronic industry at that time and noting that it is for use only with customer's understanding of its goals. Is that one of your short term trading lists?

A I missed one key word there, please.

The Presiding Officer. Will the reporter read his question?

(Question read by the reporter.)

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SEC

The Presiding Officer: Is that a quotation,  
Mr. Paul?

Mr. Paul: This is a quotation. "Is for us only  
with customer's understanding its goals."

There are other parts. It is not a part of the  
master list but relates to intermediate capital gains.

Witness Van Tuyl: This was probably a one-time  
publication a series of widespread inquiries on the  
Electronics stocks where we tried to put the entire area  
in perspective.

By Mr. Paul:

Q But you have a short-term trading list which  
deals with technical aspects, trading aspects, and so  
forth?

A That is right.

Q Now, as to your master list, this list, I take  
it, indicates the current thinking of your research depart-  
ment at the time of its issuance as to whether the list had  
securities, that is, the securities listed in the list,  
should be both, held or sold; is this correct?

A The list only includes those which are rated as  
a buy or a hold. If we think that a security which is  
in a hold position is one which should be sold, we merely  
advise that it is being removed from the list.

The significance of that advice is well-known to

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the organization.

Q On the basis of a wire amendment correcting this list?

A That is right.

Q You notify the offices that a stock has been removed from this list and this constitutes the research department's opinion that the security should be sold?

A That is right.

Q Is this master list a major tool of your supervisory function?

A It is a major tool for us by the salesman. It certainly presents a master criterion by which , or the extent to which they will follow and the firms recommendations could be measured.

To that extent the manager could use it as a test and use it in the exercise of his supervisory responsibility.

Q What is the firm policy with respect to salesmen recommending either a purchase or a sale of a security which is not contained in this list?

A This is a question not so simple to answer as it is to ask.

We have no outright prohibition which has the effect of forbidding a salesman from soliciting an order of purchase of securities not rated as a buy on the firm's

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master list or for that matter, not having been commented on affirmatively by the firm.

The analysis of security values and their relationship to price sadly enough remains an art and not a science.

We have made our share of mistakes in our New York research department. We overlooked many situations. There have been others brighter than we who noticed them. What we have endeavored to do is by persuasion and by example, and with the utmost emphasis that we can bring to bear to get our organization to follow the lead of a firm and confine themselves as largely as is practical to the solicitation of orders and securities recommended by the firm.

To give this perhaps a little more force and effect, we have in recent months spelled out a little bit further the strength of conviction we have along these lines.

Our organization, for instance, is on notice that in the event the purchase by a client of a security not recommended by some agency of the firm results in the expression of dissatisfaction by the client, this can be the cause of disciplinary action up to and including termination by the firm.

The Presiding Officer: Why would it be so hard to have a rule that a representative could not solicit

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orders for anything that was not on the approved list?

Witness Van Tuyl: I think it would mean arrogating to ourselves, Mr. Presiding Officer, a sense of all wisdom that we don't think we have.

We have seen too many cases where intelligent perceptive representatives on our staff through what exposure they may have, have gotten a sense of conviction, based on fundamentals, about a security which we had passed by.

Where if we had prohibited their soliciting orders from a client we would have done that client a disservice. I can't tell you how frequently this happens. I know it happens all the time.

So far we have been reluctant to be as arbitrary as to say that unless we say yes, you may not solicit an order for a security.

Mr. Safanie may want to comment on this.

The Presiding Officer: In this sense you sort of let your representatives supplement your research department. You let him be his own research department?

Witness Van Tuyl: That is right. This is not without some kind of follow-up. Our managers are enjoyed, and we can discuss this at some length later, to make any number of reviews of transactions completed with a view to determining the extent to which and the instances in

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which our registered representatives are securing orders in securities not researched or recommended by the firm and to make suitable inquiry at the time it happens.

We research the right obviously to raise any question we choose to as to concentration in a security with which we are not familiar or whose merits are not known to us.

But we have not seen fit to establish an outright prohibition which forces a person to confine his activities solely to that group of securities on which we are commenting.

By Mr. Paul:

Q If I understand your policy, your policy is that a salesman may solicit the sale of a security which is not on this list, and if it results in customer complaint he may then be held responsible; is that correct?

A That is correct. May I add just to give point to this?

In the New York City area in 1961, we asked for and received the resignations of three salesmen who consistently were loners, if you will, in the sense that it seemed a great majority of their business was in securities not recommended by the firm.

This we felt was a deviation entirely too great for us to abide.

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The Presiding Officer: What did you call them, loners?

Witness Van Tuyl: Loners. People who operate of and by themselves. L-o-n-e-r-s. I will try to use more formal English.

By Mr. Paul:

Q How many stocks altogether, or securities altogether, do you list in your monthly list?

A On the master list?

Q Yes.

A I am almost guessing now but I guess around 300, Mr. Paul.

Q Are there types of securities which you do not list on that list? Categories of securities of any kind?

A Certainly the restricted list the SEC puts out on the Canadian stock. Or any other security which has a legal or quasi legal prohibition against solicitation.

Q Do you have any listing of what was referred to this morning as a penny stock?

A It is extremely unlikely that any stock which is in the penny stock category would ever get on that master list. I can't point to a policy which says that one may not be placed on there.

I have never seen one on there nor can I imagine one being there.

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Q How would you define a penny stock? This morning inflation took over and the penny went up to \$2.00.

Witness Safanie: If I could say here, I doubt if you would ever find or find there has ever been on that list a stock selling under five and very few under 10.

I just can't think of any. These lists are reviewed by partners of the firm.

By Mr. Paul:

Q Do you have any policy with respect to Regulation "A" offerings, that is, offerings not registered or not fully registered with a Securities and Exchange but offered under the exemption for offerings of \$300,000 or less?

A We have no prohibition against executing orders in Regulation "A" issuings after they are free to trade, no.

Q In connection with the recommendations by your salesmen, do you think that it is possible or likely that your customers relying on the sales phrase, The House That Research Built, assume that recommendations are backed by the research department?

A I could not blame a client from taking that inference. I have used that in the persuading I have done with the members of the organization to stay close to shore and use our ideas because the clients expect them

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to be our ideas.

Q It is not your firm policy to restrict him to such?

A No. For the reasons we enunciated. We have suggested to him that this has not been a recommendation of my firm. But I believe deeply the following about so and so security.

Q So that a salesman who is recommending a security which is not on your master list is by your policy required to state that it is not?

A Again not required. We are hopeful that they do it. I can't point to a policy directive which requires it and demands it. These are things we have discussed in manager's meetings and sales meetings in branch offices.

Q You have described the master list as one aspect of supervision. I take it that there are many other supervisory methods which you use in connection with your firm's branch office operations.

Could you describe for us the internal controls that branch offices have in connection with supervision of the sales made by their personnel?

A Yes, sir. These happen at various points in time with a view to trying to take preventive action. Every one of our offices, the order clerk or the teletype wire operator has been trained and is instructed to bring

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before transmission to New York to the attention of the manager any order which smacks of the unusual in any respect either in terms of its size, in terms of the nature of the security or whatever his sense of feel developed over a period of time may give him.

This gives the manager a chance to take preventive action if such is called for.

Q This is the wire operator?

A Or order clerk, as the case may be.

Q In a local branch office?

A That is right.

Q And he brings this to the attention of the branch manager and the New York office?

A The branch manager of the branch in question. It is up to him to use his discretion how far he investigates and satisfies himself on its propriety.

The same thing is true in New York or any other point of discussion, if it is a Chicago order or Los Angeles. If the person who is charged with executing the order senses anything unusual about it, either in terms of its size or its price, it will again be brought to someone's attention.

I don't think this happens too frequently except in cases of technical impropriety. In any event, every day prior to the end of the day the manager of a branch

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is given a copy of all the reports of the discussions of orders for his office for that day.

He is required to review those before that day is over. On either the next day or the second day, depending upon mail time, the branch manager is in possession of at least two other documents which are documents for control purposes.

One of these is a listing for each representative in his office of all the transactions on the day in question grouped by client.

This indicates the details of the trade and being grouped by client as it is, gives him a day by day chance to observe the activity in a given client's account, to raise any questions if there is suspected over-activity.

With respect to the entire day's trading of the man by himself to get some sense of feel as to the kinds of securities in which he is dealing.

The other document which comes into the office is a complete bookkeeping run which shows for the day in question all entries in the accounts of the clients of that office for that particular day.

It is more generally used as an accounting document but nonetheless it is an information document available on a daily basis.

Q So on a daily basis the branch manager has reports

11 from his wire operator or order clerk of any particular incident. He also reviews all order discussions at the end of the day.

Then he has a mechanical sheet which permits him to check the activities of each account and each salesman?

A That is right, on a daily basis.

Q Are there reviews on a longer periodic basis?

A Every month the branch manager has sent to his attention a copy of the statements for all the clients in his office.

These statements reflect every bit of accounting activity and trade activity and presents at the conclusion thereof a listing of the securities the client has lodged with us.

We urge most strongly any one area of a manager's responsibility, it is the utmost need for diligent, careful review on a monthly basis of the composition and content of client's accounts as reflected by these statements.

Getting back to some of your other areas of control on a daily basis, over and above the information flowing to a branch manager, there is certain data which flows to us in New York for the entire system.

There is available each and every day a complete transcript of all transactions for employees' account. I might add that employee accounts and partners accounts

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are distinctively codified so that anybody who has an order for a partner or employee knows it immediately and can see to it that at no time does it ever conflict with the handling of a client's order.

Additionally, a complete transcript of employees trades is put before a partner each day. Beyond that a complete takeover of transactions by security system which is placed in the hands of the partner in research and partner on the floor showing the total purchases and sales of the firm on the preceding day by security and listing variously the participation in the purchases and sales by a dozen different offices, the others being grouped as one total.

The Presiding Officer: I take it you are pretty dependent upon electronic machinery in processing for control of your total offices?

Witness Van Tuyl: It is almost indispensable for any kind of day by day control, sir.

The Presiding Officer: How long have you had electronic tie-in and data processing in your office?

Witness Van Tuyl: Since the fall of 1949.

The Presiding Officer: And all of your branch offices are tied into the same system?

Witness Van Tuyl: That is right. The book-keeping for the entire firm is centralized in New York

City.

By Mr. Paul:

Q If I understand it, sir, in your home office in New York there is a daily review of employee accounts, and also has an electronic run by securities which is reviewed both by the Research Department and by the floor department?

A That is correct, sir.

Q What are the particular problems which are intended to be caught by the daily run transactions?

A Over concentration in an issue whether or not recommended by our firm. Certainly concentration of any business done in an issue with which we are not familiar or the merits of which are unknown to us.

It gives our Research Department and our floor people a little sense of feel of the part of the country from which interest is being evidenced.

Q This is over concentration in an issue. Is this subject to review by both research and the floor department?

A That is right.

Q Are they both looking at that?

A Yes. We have had cases where the Research Department made an affirmative report on a given situation and for reasons which we are frequently unable to forecast is particularly attractive to our organization.

They will make it a point to make a little tally

day by day of the volume that a firm is buying in a given situation. They will watch the volume vis-a-vis the price. They said this made good sense at 45 but the stock is now selling at 47 or 48 we would not reach for it.

Take your time. Don't be too active in the security. To avoid in that case over-indulgence in something which we have recommended ourselves.

Q This is for the purposes of keeping your research section up-to-date on price and on its recommendations, I take it?

A On the follow-through on recommendations; that is right.

Q Beyond this, what other types of controls, supervisory controls, do you exercise?

A At least once a year the Research Department and the manager of the branch receives what we call a stock record takeover.

This is a complete transcript of all security positions for all clients and an office grouped by security. It is a report, for instance, which would demonstrate to the manager of our Chicago office that the firm is holding "X" hundred or thousands of shares of the American Telephone Company for the following clients of the Chicago office.

So many shares of Babcock and Wilcox and Chrysler. It is a tool by which we can evaluate on an

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annual basis over-all concentration by issue.

Q What sort of control do you use to insure that the particular recommendations with respect to particular customer's accounts fall within the New York Stock Exchange and in ASD rules as to suitability?

A That is largely a matter, I think, Mr. Paul, first of continuous, consistent training of your RR to dedicate themselves to that concept.

We do not require the retention or the notation in our records, I should say, of a stated categorical investment objective of our clients.

On the contrary, the review we make attempts to seek what does the client have. If any flags wave from that on a monthly basis, we think this is the way you can correct any damage that is being done or change the course of the conduct of the account much more effectively than you can through some simplified and perhaps over simplified statement of objective.

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By Mr. Paul:

Q It is your manager's monthly review of each account statement that you use to rely on for a tool for suitability?

A We have heavy reliance. Over and above the manager's review, it is obviously impossible for the partners in New York to look at every statement every month. Several of us on a spot check ask for a duplicate statement for these men in this particular office or that, to look at them ourselves to get a little sense of feel as to the kind of business a particular man may be doing or a particular office may be doing.

Q Does the monthly statement contain information as to other assets, liabilities or income of the customer?

A No, sir.

Q Is the manager expected to be aware of that with respect to those statements he reviews?

A No. We ask our men to do their best to acquaint themselves with the client's situation. It is not always possible to get this information. Some people consider it to be personal, private. We endeavor to point out that to do a professionally competent job, we need to know the circumstances. It is one thing our men try to find out in the first instance.

Q It is a policy of the firm to attempt to acquire such information?

A We din into our men the importance of knowing your customer, know what his circumstances are.

Q But the information, when acquired, is kept by the registered representative and is not generally reviewed by the branch manager when he reviews the monthly statement?

A That is correct.

Q Are there particular controls which you rely on with respect to such problems as over-trading or churning?

A Again this shows up or can show up on the daily take-off which the manager gets by salesmen of the business done in each account for the day. It can certainly show up at the month-end review of the statement. It does not take too practiced an eye to look at a month-end statement in terms of the size of his debit or credit balance, the number of items in what we call the bring-down, which is the security position and the volume of transactions which stand out in the body of the statement. It is almost a sight calculation. The old data processing machine can do it pretty quickly for you.

For the sake of argument, if at the end of the month a man has two securities on deposit with our firm and has a debit balance of \$6,000, which was \$5,000 the month before, and had 35 trades, you don't have to be a genius to wonder what is going on here. I am obviously citing an extreme. I can assure you it is a hypothetical case.

Nonetheless that is the kind of thing which a quick review of the statement makes readily apparent.

Q There is a data processing machine which you indicated by your finger was your head?

A That is right.

The Presiding Officer: Mr. Van Tuyl, with reference to the research bulletins and advisory follow-up bulletin that you described before, are they essentially factual and descriptive in nature, or do they tend to be advisory in nature?

A They are both. I think they can best be characterized by saying that they present the findings of fact which must be firsthand and must be facts which our analyst is prepared to prove are facts and that have been derived from proper sources. There must thereafter be some reasoned conclusions and final recommendations.

We publish very little from our research department with respect to a given issue that doesn't, as we say, come to the point and suggest what we think the investor should do based on the facts and conclusions we have reached.

The Presiding Officer: Do they contain advice to buy or sell as you might have concluded from your research?

Witness Van Tuyl: The semantics of the industry are such that you will wind up by saying that this is a security which is attractive for intermediate term appreciation,

or for those who are looking for a conservative investment with a better than average yield, this is recommended. We try to characterize the recommendation in terms of what it is good for or whom it is good for.

The Presiding Officer: Suppose you have an advisory follow-up situation and you begin to take a dimmer view of the security than perhaps you did in the original bulletin, what is the semantics of the situation there?

Witness Van Tuyl: There would probably be some indication that earnings are not living up to expectations or projections that had been made. There might be some reaffirmation of what continues to be good and a final conclusion that prospects over the near term don't look particularly attractive.

The Presiding Officer: You might say unattractive?

Witness Van Tuyl: You might say unattractive, precisely.

By Mr. Paul:

Q Did I understand you to say, sir, that your master list has a method of classification of different bases of the different types of portfolios for which the different securities listed might be appropriate?

A We publish at the end of the master list tabulation, I believe, three or four different sample portfolios, saying, for instance, "As of this month end if you are looking for a

\$25,000 portfolio for high yield, here is the suggestion of four or five securities to compose such a portfolio. If you want a growth type portfolio, here is the selection." These are suggestive. Trying to do, in effect, the salesman's job for him in some areas.

Q But the list generally simply lists the company, industry and the recommendation?

A That is correct, sir.

Mr. Paul: Mr. Presiding Officer, at this point we would like to ask the Shearson, Hammell witnesses some questions relating to certain activities in their California offices in 1960 and 1961. I am going to ask that Mr. Rothberg, of the study staff, do the questioning.

By Mr. Rothberg:

Q Mr. Dunbar, would you please state your general responsibilities and activities in connection with your employment with Shearson, Hammell?

A My general responsibilities and activities, I am designated as senior partner on the West Coast in charge of the West Coast offices. I check with New York -- I go to New York every other month -- and advise with them on various problems and they advise with me on various problems. I do a general supervisory operation primarily through the managers.

In addition to this, I do have a large retail clientele of my own.

Q You then report to no one on the West Coast?

A That is correct.

Q Can you tell us what office, if any, you work out of on the West Coast?

A I am located in the Los Angeles office at the present time.

Q Can you just state briefly what the nature of your employment has been with Shearson, Hammell since you first came there?

A I sold them my business in 1949 and became associated with them in the Beverly Hills office in 1951. I went to New York in charge of the business promotion department, which I guess you can characterize in other language as the sales department, and supervised the training activities. In 1954 I returned to California as registered representative.

Approximately 1956 I became a general partner of the firm.

Mr. Rothberg: Mr. Teweles, could you briefly describe what your responsibilities and activities, in connection with your employment by Shearson, Hammell, are?

Witness Teweles: Basically I act as manager of our Los Angeles office.

Mr. Rothberg: How long have you been employed by Shearson, Hammell?

Witness Teweles: Four years.

Mr. Rothberg: Could you just briefly trace your responsibilities and your activities in the last four years?

Witness Teweles: In 1958 I acted as assistant to the partner in our Chicago office; in 1959 I became manager of our office at Los Angeles. In 1960 I became a general partner in charge of our office in Los Angeles.

Mr. Rothberg: Mr. Dunbar, could you describe at this time your connection with a company known as United States Automatic Vending Machine Company, which we will call USAMCO, for short, the initial financing and subsequent public issuance of stock of that company, the history of sale of that company stock, including in general the activities of the Shearson, Hammell salesmen in selling and buying that stock for their customers, generally the financial history of the company, and the nature of the supervisory activities in connection with the sale of that stock?

Witness Dunbar: That is quite a long question. I wish you would break it down a little bit.

The Presiding Officer: Perhaps the reporter can re-read the question and then, if you would like, to have it broken down, Mr. Dunbar.

Witness Dunbar: Mr. Presiding Officer, I would like to have it broken down into a few sections because I doubt if I can remember each one of those and get them all in.

Mr. Rothberg: Perhaps you can refer first to the

initial financing of the company's common stock.

Witness Dunbar: I believe the initial financing of the company's common stock was 10,000 shares of organization stock bought by two gentlemen, 5,000 shares apiece. Subsequently, in the common stock there was an offering of 290 shares of stock by the company under Regulation A.

The Presiding Officer: What was the date of this, Mr. Dunbar?

Witness Dunbar: November 8.

Mr. Rothberg: Of what year?

Witness Dunbar: 1960.

By Mr. Rothberg:

Q What was your connection with the company?

A I became a director of the company.

Q When did you become a director?

A I believe around July or August, 1960.

Q Was that prior to the public offering of the company's common stock?

A Yes, sir.

Q Were you one of the original organizers or promoters of the company?

A No, sir.

Q Would you describe briefly the circumstances leading to your directorship?

A My directorship? The organizers of the company

asked me if I would serve along with them as a director.

Q Who were the organizers of the company?

A Mr. Richard Stevens of the company, Mr. Thomas Foye.

The Presiding Officer: If I may interrupt here, I think that the purpose of Mr. Rothberg's question might have been in a broad form, to give you an opportunity to state broadly the history of this transaction, and when I said you can have the question broken down if you wanted to, I did not mean to deprive you of the opportunity to describe the transaction in your own words, if you would like to do that. By the transaction, I mean generally offering the scope of the history, of your knowledge, of the financing and your participation and Shearson, Hammell participation.

If you would like to make a general statement, I don't want to deprive you of that opportunity.

Witness Dunbar: Thank you. I would be glad to do it. I think whatever is easier for Mr. Rothberg. Would you rather me describe it or ask questions?

Mr. Rothberg: Perhaps you can describe it in your own words.

Witness Dunbar: You asked about the common stock, and I answered.

Originally there were several hundred thousand of debentures sold privately under letter of investment. I believe they were ten-year debentures, 4 per cent coupon, not

convertible into common stock for one year and then convertible into the stock at one dollar a share. No interest for two years, no sinking fund for three years.

Mr. Rothberg: Can you continue and just generally describe the activities of Shearson, Hammell after the company offered the stock to the public?

Witness Dunbar: Shearson, Hammell and Company, after the company had offered the stock to the public, I imagine because I was a director of the company, we received a great many inquiries. At that time the vending industry was discussed in practically every magazine, every newspaper.

The vending stocks were having a great ascendancy. This was a company connected with the vending industry. There was a great deal of inquiry all over the country. I believed it would be highly successful. I thought they had a fine idea. I believe some of our salesmen -- it was not generally sold through our sales organization, I do not believe it was even to be classified as generally sold throughout southern California after the original offering. I think it would show that a minority of our salesmen, rather than a majority, sold stock to the customers. Many of them were quite interested in the vending business.

The Presiding Officer: Are you talking about the distribution under Regulation A offering or subsequent trade?

Witness Dunbar: No. Shearson, Hammell had no

part of the distribution of Regulation A. I am talking about after Regulation A was distributed and our subsequent market.

Mr. Rothberg: Do you have any other general comments you would like to make concerning Shearson, Hammell activities after market, or the distribution, or after market trading of the stock?

Witness Dunbar: I would say for an issue of this type there was a rather disproportionately large activity by all dealers. I would say that there was more activity by New York Stock Exchange houses than I would normally see in a deal of this kind. I would say our own volume of transactions would be a little heavier, not too much heavier. But in proportion, our volume of transactions to the volume done on street transactions, where we were primary market, in a situation of this kind it was rather heavy on the street side in the type of houses that bought it on the street side.

The Presiding Officer: What do you mean by street transactions?

Witness Dunbar: Dealings we had with others. We did maintain a market in USAMCO stock. Not only practically all of the small over-the-counter houses but practically all of the New York Stock Exchange firms placed buy and sell orders through us all during the history of this.

The Presiding Officer: You say your street dealings

were proportionately higher?

Witness Dunbar: No, I said they were proportionately higher, in my opinion, than you would normally have in this type of an operation. I don't know whether I made myself clear, but that may clarify it.

Also, we received quite a few inquiries from around the country, which were a little abnormal in relationship to a local California deal. I recall houses in Nashville, in Chicago, Detroit.

The Presiding Officer: You had only 300,000 dollars of stock?

Witness Dunbar: Originally that was it. I am talking about later on. He asked me in the after market.

Mr. Rothberg: At what price was the stock offered to the public?

Witness Dunbar: One dollar a share.

Mr. Rothberg: Could you trace briefly the prices that security sold in subsequent months?

Witness Dunbar: The stock traded from \$3 a share to a level of about \$5 1/2 a share.

The Presiding Officer: What dates are you talking about?

Witness Dunbar: I am talking November 14 to approximately December 1st.

The Presiding Officer: Of what year?

Witness Dunbar: Of 1960. December 1st it stayed from approximately \$6 a share to -- wait a minute, approximately \$6 a share to approximately \$7 a share through December 26, 1960. Then it was approximately \$7 1/2 a share with a drop-down one time to \$6 a share, all the way through, and again it dropped down to \$6 1/2 a share until January 12.

Mr. Rothberg: Mr. Dunbar, what was the stock selling at by the end of January, 1961?

Witness Dunbar: At the end of January, 1961, the stock was selling at \$12 or \$13 a share.

Mr. Rothberg: What was the stock selling at by the end of March, 1961?

Witness Dunbar: March, 1961, it was selling at approximately \$18 a share.

By Mr. Rothberg:

Q \$18 a share?

A Yes.

Q ~~What~~ was the stock selling at by the end of May, 1961?

A End of May, 1961, it was selling at approximately \$17 or \$18 a share.

Q What was it selling at by the end of June?

A End of June it was selling at approximately \$11 a share.

Q Let us get around to August 31. What was it selling

at then?

A August 31, approximately \$9 a share.

Q What was it selling at by the end of September?

A Approximately \$4 1/2 to \$5 a share.

Q What was it selling at by the end of November, 1961?

A Approximately \$3 a share.

Q By the end of December, 1961?

A Approximately a quarter to a half dollar a share.

Q What is the stock selling for now?

A I don't know. I would say the same price approximately.

Q Was Shearson, Hammell making a market in that security starting November 14, 1960, through December 31, 1961?

A Yes, sir.

Q For significant periods of time was Shearson, Hammell the only person who appeared in the sheets of the National Quotation Bureau making a market in that security?

A That I don't know, sir. I know from time to time there were other houses making a market, but I have not checked the sheets. I think it would be a fair assumption, however.

Q Would it refresh your memory that Shearson, Hammell was the only house in the sheets from March 23, 1961, through July 6, 1961?

A As I said before, I did not check the pink sheets,

but I assume it is an accurate statement.

The Presiding Officer: Mr. Dunbar, you mentioned the pink sheets. Was this a western market or is this a national market?

Witness Dunbar: When I say pink sheets, I am referring in general to the National Quotation Bureau sheets. The pink are New York. I forget whether it is white or green for the other one.

The Presiding Officer: Was this a market which from the point of view of your firm was being made in your Los Angeles office as distinguished from your New York office?

Witness Dunbar: That is correct, sir.

By Mr. Rothberg:

Q Can you tell us briefly what the financial condition of the company is at the present time?

A I have only heard. The company at the present time, and I must say it is hearsay, they have sold -- they will be able to pay off their debts and have about \$25,000 cash and \$125,000 in notes and receivables from the liquidation of assets. This I have heard.

Q Have you seen any letters directed to stockholders in March, 1961, which indicated that the company was in the process of liquidation? I mean 1962?

A Yes, sir.

Q And your opinion on the company's affairs is based

in part on that letter, I take it?

A That is correct, sir.

Q Let us go back now to the period prior to November 14, 1960, prior to the offering of the company common stock.

The Presiding Officer: Mr. Rothberg, are you finishing a subject or starting a subject, or what? If you are starting one, I would like to suggest that we recess at this time. If you are finishing one, I will hold the hearing a little longer.

Mr. Rothberg: I think this would be a convenient time for a recess.

The Presiding Officer: The hearing will be in recess until 10:00 a.m. tomorrow morning.

(Whereupon, at 4:35 p.m. hearing in the above-entitled matter was recessed, to reconvene at 10:00 a.m. Thursday, May 17, 1962.)