

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

Docket No. _____

In the matter of _____

Place _____

Date _____

Pages _____

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BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

In the Matter of: :

SPECIAL STUDY OF SECURITIES MARKETS : :

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: ^With 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, nictotines 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."