

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.

wil ends

bowflsow

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

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

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

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

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

By Mr. Moss:

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

A That is enough.

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

By Mr. Moss:

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

A Did I learn?

Q Yes.

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

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

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

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

A Yes, this has come to my attention now.

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

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

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

A That is correct.

Q And there was a cocktail party?

A That is correct.

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

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

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

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

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

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

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

end, or both?

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

By Mr. Moss:

Q Does Los Angeles have a research office?

A They do not.

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

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

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

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

Q I understand that.

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

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

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

Q Do you know how many were solicited?

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

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

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

A Yes.

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

A That is correct.

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

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

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

A This would never have happened.

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

A Right, and it will never happen again.

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

A Very definitely.

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

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

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

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

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

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

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

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

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

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

By Mr. Moss:

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

A That is why we fined them.

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

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

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

A That is correct.

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

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

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

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

Mr. Moss: Yes.

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

By Mr. Moss:

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

A Good lord, no.

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

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

Q With respect to representations to persons to

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

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

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

A Definitely. It would not be recommended.

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

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

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

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

A No.

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

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

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

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

"He said this plant would provide 30,000 square feet of floor space and would employ 150 people.

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

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

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

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

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

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

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

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

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

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

Witness Regan: Thank you, sir.

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

By Mr. Moss:

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

"NLF being duly sworn deposes and says:

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

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

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

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

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

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

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

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

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

The Presiding Officer: In the course of whose investigation?

Mr. Moss: Merrill Lynch's investigation.

Witness Regan: In the course of our investigation?

By Mr. Moss:

Q Yes.

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

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

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

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

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

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

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

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

A Eight.

Q Eight were disciplined.

A Yes.

Q Were they all in the Pasadena office?

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

Q What was the general nature of the discipline?

A Fines.

Q Any suspensions?

A No, fines and reprimand noted on their record.

Q Can you tell us what the largest fine was?

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

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

salesmen leave?

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

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

A Yes.

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

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

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

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

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

A Definitely.

Q When you say you made restitution --

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

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

A Yes.

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

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

Q Did you contact the customer to find this out?

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

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

A Yes.

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

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

The Presiding Officer: Proceed.

By Mr. Moss:

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

A Yes.

Q Was he on duty at that time?

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

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

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

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

A No, he was not.

Q The next day there were also substantial purchases?

A That is correct.

Q Did he handle the problem in any way?

A No, not to my knowledge.

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

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

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

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

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

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

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

A Definitely.

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

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

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

A January 1962.

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

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

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

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

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

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

The Presiding Officer: Yes, I wish you would.

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

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

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

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

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

Witness Regan: That is correct.

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

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

By Mr. Moss:

Q I would like to ask a couple of questions about

mutual funds and your views on them.

A Yes.

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

A That is correct.

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

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

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

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

Q Does Merrill Lynch get much portfolio business from funds?

A We get some, but not much.

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

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

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

A Last year about \$400,000.

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

A Yes.

Q More so than open end funds?

A Honestly I have never broken the figures down.

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

A Managers. About 55 out of our 60 offices are

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

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

A I said an account executive may take a cut.

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

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

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

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

Witness Regan: Yes, sir.

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

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

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

Witness Regan: That is correct.

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

(Witnesses excused.)

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

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