# "THE PROBLEM OF BROKER SOLVENCY"

ADDRESS

of

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In the public mind, the major function of the Securities and Exchange Commission is to "protect the investor". This is both accurate and natural. The 1932-34 investigation into the folkways of finance, conducted by the Senate Committee on Banking and Currency, revealed more than adequately the necessity for a public protector for the investor. This investigation was the direct ancestor of the SEC. It thoroughly acquainted the public mind with the clash of interests involved in financial activity, and the ground was fully prepared for the establishment of a public power which would hold in check the unbounded rapacity of an amoral financial system. The accuracy of the public concept of the Commission's function is attested by the frequent repetition of the phrase, "for the protection of investors" in the statutes administered by the Commission.

Of course, the activities of the Commission cannot directly heal the individual financial wounds of the little man who has been burned in the market. But the SEC welcomes complaints from such individuals because they frequently point up situations which can be attacked for the protection of investors in general. Moreover, in the present situation of rapport between the Commission and the stock exchanges of the country, sore spots which have been exposed by complaint can frequently be referred to the appropriate stock exchange for action; of course such action can be much more flexible and summary than the slow laborious processes of law which the Commission perforce follows scrupulously in all its proceedings.

In general terms, the SEC is authorized to adjust the machinery of finance, within the limits established by the laws it administers, so that the individual investor, acting on his own initiative, can avoid being crushed. The three Statutes which the Commission administers wholly or in part are aimed in this direction. The Securities Act of 1933, "the truth in securities Act," requires issuers of new securities to expose their inner corporate workings to the public whose investment funds they seek. The Securities Exchange Act of 1934 attempts to assure the fair treatment of investors in the process of trading securities. The Public Utility Holding Company Act of 1935 aims to permit the investor to protect himself against potential dangers involved in the use of the holding company device in utility corporations. Under all these statutes, the SEC performs important administrative functions. In addition, Chapter X of the Bankruptcy Act of 1938 places the SEC in the position of expert advisor to bankruptcy courts in corporate reorganizations, in order that they may be fully apprised of the rights of various groups of obligees and owners wandering in the wilderness of modern corporate practice.

On certain phases of financial life, the Congress evidently wished added information before enacting appropriate legislation, and it directed the SEC to study and report on them. For example, the Securities Exchange Act of 1934 directs the Commission "to make a study of * * * protective and reorganization committees" in corporate reorganizations. This study, exhaustively carried out during 1934-37 under the supervision of William O. Douglas, now Chairman of the Commission, shed a flood of light on the domestic life of corporation finance. The seven-volume report to Congress on this subject is a veritable treasure house of material revealing how corporations act. In large part this report led to the enactment of the new Federal Bankruptcy Act of 1938. Parenthetically I might suggest that were I now teaching in the fields of corporation finance or business law large parts of this report would be required reading for my students. The SEC was directed by the Public Utility Holding Company Act of 1935 to make another special study covering investment trusts and investment companies. This work is still in process but part of its results are now available in mimeographed form. They also are important sources of knowledge about financial habits, of special interest in the study of investment banking and investments.

Another method whereby the Commission "protects the investor" is by the promulgation, after appropriate study, of rules and regulations giving effect to certain sections of its organic statutes. This method is used in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. In the Federal Bankruptcy Act of 1938 the position of the Commission varies somewhat from this pattern -- it is essentially an expert advisor rather than a regulatory body, but in this role it still "protects the investor."

This administrative power to promulgate rules and regulations with the force of law has been bitterly attacked as one of the major methods whereby the New Deal is regimenting America into a dictatorship. Last July the Administrative Law Committee of the American Bar Association under the chairmanship of Dean Roscoe Pound launched a sharp attack against this trend in our federal government, colorfully characterizing it as "administrative absolutism." In an equally colorful reply before the Georgetown Law Alumni Club on November 9 last, Commissioner Jerome Frank of the SEC pointed out certain errors in both the facts and arguments on which Dean Pound had based his contention. In addition, Commissioner Frank ably disputed the Dean's assumption that quasi-judicial administrative agencies are per se hostile to the courts and hence tend to supplant them.

The shortness of human memory is at times amazing and at times discouraging. The quasi-independent administrative agency became a part of our Federal structure well back in the nineteenth century. It has played an increasingly important part in both Washington and the state capitals ever since. Naturally such commissions have varied widely in their purposes, powers, and length of life. But it is hardly valid to argue that the New Deal, in facing a kaleidoscopic economic and social environment, is erecting a dictatorship out of materials that became an integral part of our governmental structure long before the advent of either the "Square Deal" under Roosevelt I, or Woodrow Wilson's "New Freedom."

As Commissioner Frank so aptly points out, in our present highly complex industrial civilization a flexible administrative system, capable of maintaining reasonable checks on a constnatly changing social structure, is the alternative to an industrial paralysis resulting from statutory rigidities unsuited to an America whose most characteristic attitude has been one of growth and change. I wish to give particular attention to one of these "administrative absolutisms," one of these nefarious novelties which a 1934 Congress, free from any suspicion of WPA paternity, enacted into law and directed the newly-established SEC to perpetrate on an unsuspecting American democracy.

In the Congressional hearings preceding the enactment of the Securities Exchange Act of 1934, some attention was given to the problem of maintaining the solvency of those brokers who seek the security trading business of the public, in order to protect funds and securities belonging to customers. Obviously, the intricacies of this subject, involving complex accounting and technical problems, do not lend themselves to satisfactory direct legislative treatment. It was proposed to place in the hands of the SEC, to be established by the bill, certain permissive administrative powers over this matter. Quite understandably, Mr. Richard Whitney, then President of the New York Stock Exchange, opposed any such "administrative absolutism," and maintained that the investigation machinery of the New York Stock Exchange was quite sufficient to cope with the rare cases of dishonesty among its membership. In the course of his testimony before the Committee, Mr. Whitney said,

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> "No statutory provision can guarantee the solvency of brokers. Constant care and watchfulness are the best protection against insolvency. * * *
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> "I have never known an instance where a report has been made by a member of the stock exchange that was untrue that it was not eventually found out, because we have our own auditors going into those books."

Subsequent events proved Mr. Whitney to be quite accurate. But "eventually" is not soon enough to assure customers' protection. In the Whitney case, "eventually" meant some twelve years -- at least from 1926 to 1938.

However, the New York Stock Exchange has been rightly proud of the solvency record of its member firms. In the years between 1922 and 1937 only thirty-seven member firms were suspended on account of insolvency; during 1938 there has been only one. Speaking generally, the curve representing annual failures of New York Stock Exchange member firms has run at less than one per cent of all member firms.

Perhaps it is worth while to mention one factor which is rarely mentioned, but which has surely contributed heavily to this enviable record. Security trading practice in the United States requires sell-outs by brokers when their customers' equities fall too low. Since the American trading public knows much of margin purchases and little of short sales, customers' equities generally exist in the form of securities pledged against bank loans. In view of this fact, customers' equities tend to disappear primarily when prices fall. Hence, brokers' sell-outs of customers' undermargined accounts appear largely on the decline, thus increasing the downward pressure, nibbling away customers' equities still further, and contributing heavily to a vicious downward spiral. The short selling rules of the Commission, promulgated last February pursuant to Section 10(a) of the Securities Exchange Act, contemplate that active "bears" shall be prohibited from aggravating such demoralized price situations, although short selling under ordinary circumstances is not limited. Of course, it is impossible to estimate the social cost involved in this type of security practice, but obviously it places a premium on broker solvency at the expense of relative price stability. However, despite the excellent record of the New York Stock Exchange, from time to time a member fails, usually with accompanying losses to the public.

For many years the New York Stock Exchange has had numerous rules directed toward maintaining the solvency of its members. In 1922 a system of questionnaires was established, requiring periodic reports of financial condition from all members carrying margin accounts. In 1924 the Committee on Business Conduct of the Exchange required answers to these questionnaires to be based on an audit conducted either by the firm's own employees or by certified public accountants, at the firm's option. Firms not carrying margin accounts merely filed a letter so stating; no check was made as to the accuracy of these statements. Moreover, Exchange auditors might visit a member's office at any time in order to investigate his financial condition, although such a visit usually followed quite promptly after the submission of a questionnaire by the firm, and frequently contained no element of surprise. Also, by settled practice, minimum capital requirements were established for members of the Exchange dealing with the public, as well as minimum margin requirements for customers' accounts. The minimum capital requirements were necessarily low, which, combined with their flexibility and ambiguity, rendered them quite meaningless as real limitations.

Despite these several buttresses to solvency, periodic failures of members continued, reaching a dramatic pinnacle in that of Richard Whitney in March, 1938. Richard Whitney's great prestige, his position of leadership among a large number of Exchange members, and his impeccable financial connections would have been sufficient to render his failure a major financial shock. But when investigation revealed that his first wanderings from the path of financial rectitude had occurred some twelve years before they were discovered, the incident left the financial world bewildered. The theory of self-government by stock exchanges was rocked to its foundations. Whitney's statement before the Senate Committee on Banking and Currency, offered in testimony on February 22, 1934, had caught up with him "eventually," and the situation footed up to the overthrow of the system he had so vigorously defended by word, if not by deed. It became clear that the solvency of brokers is a social responsibility of vital importance, no longer to be left as a shuttlecock to the mixed motives of "private club" control.

Several "administrative absolutisms" of the Securities Exchange Act of 1934 had made provision for coping with such a problem. Under Section 19, the SEC. is empowered, among other things, to alter or supplement the rules of national securities exchanges relating to (a) "safeguards in respect of financial responsibility of members," and (b) "the time and method of making settlements, payments, and deliveries and of closing accounts." Section 8(b) of the same statute authorizes the Commission by rule to prescribe for members of national securities exchanges and for brokers doing business through members, a maximum ratio of indebtedness to capital, but in no event may this ratio exceed 20 to 1. The Senate Investigation had disclosed ratios of indebtedness to capital as high as 52 to 1, and an early draft of the bill proposed 10 to 1 as the maximum. Section 8(c) of the Act authorizes the Commission by rule to prohibit members, and brokers doing business through members, from rehypothecating or commingling their customers' securities in certain circumstances. Section 15(c) prohibits all brokers and dealers from using the mails or instrumentalities of interstate commerce to effect transactions in the over-the-counter markets in contravention of rules and regulations of the Commission with respect to the financial responsibility of such brokers and dealers. By Section 17(a) the Commission is empowered to require the making, keeping, and preservation on the part of all members of exchanges and of over-the-counter brokers and dealers registered with the Commission, of such accounts, books, and records as the Commission may prescribe by regulation as necessary or appropriate.

With such an array of powers at his disposal, it is probable that an "administrative absolutist" would have thrown caution to the winds and cracked down with sledge-hammer blows. The Commission might well have resorted to the use of Chairman Douglas's behind-the-door shotgun -- a weapon somewhat reminiscent of Teddy Roosevelt's "Big Stick", and which the Chairman has described as "loaded, well-oiled, cleaned, ready for use, but with the hope that it would never have to be used." It would not have been too much to expect that a barrage of rules would have been aimed at the canyons of Wall Street by the investor's advocate in Washington.

However, the SEC had long before recognized the vital and delicate position of securities markets in an industrial system founded on negotiable instruments, and it was not prepared to endanger further the interests of investors by the promulgation of unmatured prohibitions. Even in the face of the Whitney failure, the shotgun was left behind the door. Instead of assuming the role of an administrative absolutist, the Commission proceeded to develop a "round-table technique" peculiarly suited to the problem in hand.

By means of conference and negotiation, it was possible to forge out an acceptable program of co-operative action between the New York Stock Exchange and the SEC. This program, announced as a part of the Commission's report on the Whitney case, is particularly designed to strengthen the financial position -- to assure the solvency -- of those members of the New York Stock Exchange who seek the public's security business. This program, with suitable variations, might well be a standard for broker solvency in other sectors of the security markets -- the smaller stock exchanges and the vast "over-the-counter" markets which until recently have been both unorganized and unregulated.

The program includes a number of items which bear on broker solvency both directly and indirectly. The New York Stock Exchange has provided the machinery for limiting the ratio of brokerage indebtedness to brokerage capital. Although no effective ratio has been established, it is proposed that a ratio of 15 to 1 between indebtedness and capital shall become effective on January 1, 1939. This corresponds to the Commission's proposed rules establishing a similar ratio.

The Exchange has likewise promulgated rules sharply limiting unsecured loans among members, and particularly limiting the official activity of those Exchange officials who are involved in loans to or from other members. Reports to the Exchange of all such loans by both borrowers and lenders are also required. Both of these practices which are now limited appeared in sharp relief in the course of the Whitney investigation. During the period of his financial disintegration, Mr. Whitney borrowed heavily not only from banks and outsiders, but also from exchange members and from his official colleagues who were later to be called upon to judge officially his position as a member of the exchange. The desirability of the limitations which have now been established is obvious.

The auditing and investigatory activities of the New York Stock Exchange with respect to its members also have been intensified and expanded. All member firms, whether or not they deal with the public, will be required to furnish both quarterly and annual statements of condition. It will be recalled that Mr. Whitney's firm, since it did not, according to its own interpretation, carry margin accounts, was exempted from furnishing financial statements to the Exchange authorities. In addition, independent audits will be required of the books, records, and accounts of all members doing business with others than members or member firms. Supervisory audits, examinations, and inspections of members' books by auditors of the Exchange staff, will be made more frequently and at unannounced, irregular intervals. The New York Stock Exchange has also ruled concerning the carrying of trading accounts by one firm for the partners of other firms, reports of such accounts, the carrying of security accounts for customers by individual members of the exchange, and reports of members' financial obligations with respect to underwritings in which they participate.

For its part, the Commission has stood aside, preferring to allow the Exchange every opportunity for self-regulation. However, the SEC has announced its major concern over the matter of commingling of brokers' and customers' securities; the establishment of adequacy and uniformity in the books and records which reflect the conduct of the brokerage business; and the creation of trust institutions in order to separate the banking and custodial functions of brokers from their purely brokerage or agency functions, for the purpose of protecting the interests of the investing public. These three concerns of the SEC are woven together and likewise intertwine with additional proposals of the Exchange. The Commission is directing much effort toward the drafting of satisfactory rules requiring adequate brokerage accounting records. As to the commingling of securities owned by customers and brokers, the Exchange has announced its intention of permitting its member firms to create separate, affiliated corporations for the purpose of separating firm positions from customer trading, and hence minimizing the possible commingling of these two conflicting interests. The SEC has authority to attack this problem in a less circuitous manner and has announced its intention of promulgating rules under Section 8(c) of the Securities Exchange Act in order to protect customers' securities from improper hypothecation and commingling.

One item of major importance in the Exchange program is the establishment of prohibitions on the trading activities of member firms which carry accounts for the public. The Exchange has announced that such a prohibition, with appropriate exemptions, will become effective on April 1, 1939, but no rules have yet been published. Such a prohibition, if effective, would go a long way toward removing the inherent conflict of interest between the activities of a broker for his own account, and his agency activities for customers.

In addition, both the Exchange and the Commission have announced that they are studying the possible creation of central trust institutions to take over the banking and custodial functions of brokers.

The custodial activities of brokers involve the handling of customers' cash, customers' fully-paid securities, and customers' securities representing borrowing power in excess of that which an account may require. In the course of these custodial activities, the brokers on the New York Stock Exchange handle an enormous volume of property which belongs to their customers. As of August 31, 1938, they held deposits of customers' cash in the form of free credit balances -- similar in all respects to commercial bank deposits -- aggregating approximately $272,000,000. The volume of customers' fully-paid or excess collateral securities held by brokers is not definitely known, but it has been conservatively estimated to be many times greater than the amount of free credit balances. In addition, the total market value of securities held in customers' margin accounts by New York Stock Exchange brokers is estimated at more than $2,000,000,000 as of August 31, 1938, against which bank loans approximating $570,000,000 were outstanding.

The custody of this enormous volume of customers' property -- perhaps as much as three billion dollars -- is subject to no regulation or supervision as a banking business by the government, state or federal. Its supervision has been left in the hands of the Exchange, a situation involving dangers to customers which have become too starkly clear.

The banking function carried on by brokers is an offshoot of margin trading by customers. But in this case the offshoot has almost overshadowed the parent. When the Securities Exchange Act of 1934 was under discussion before its enactment, there was some sentiment for requiring that all security trading be on a cash basis, thus abolishing margin trading. Such a requirement would have forced all banking functions out of the hands of brokers and into the hands of loan institutions of various kinds, in addition to furnishing a potential solution for other pressing problems. Fortunately, the support for such a requirement has not entirely disappeared. However, as enacted, the law provides for flexible margin requirements to be established and promulgated by the Board of Governors of the Federal Reserve System.* In these circumstances, banking functions still rest in the hands of brokers without governmental regulation of any kind.

Hence, as custodian and as banker, the broker is constantly handling both funds and securities belonging to customers. In addition, he is frequently purchasing, selling, borrowing, lending, and pledging securities, as well as borrowing and lending cash, both of which may belong to the broker, his customers, his partners or his firm. Danger to the customer arises in two ways: either through misappropriation of his property by the broker, or through an improper commingling of the property of one customer with that of another, or with property of the partn rs or firm.

The idea of central trust institutions to handle these custodial and banking functions of brokers has been given full support by the SEC. In the report on the Whitney case, the Commission states:

> " * * * The ideally effective measure for dealing with customers' free credit balances and customers' fully-paid or excess collateral securities would be the establishment of trust institutions in various financial centers. * * * Such an institution would assume all banking and custodial functions now performed by brokers as an incident to their brokerage business, whether conducted on a cash or on a margin basis."

Whether a trust institution is to act only as a depository for customers' free equities or is to function as a substitute for brokers' banking and custodial activities is of crucial importance. A mere depository institution would leave it to the brokers to answer the question, "How much customers' free equity, now in my hands, should be deposited with the central institution?" A full-fledged trust institution would answer this question for the broker in addition to having at all times full physical possession of those customers' free equities; in fact, there would be no possibility of the broker answering the vital question to his own advantage.

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* Currently, the initial margin requirements for customers other than broker-dealers acting for their customers, are 40% of the cost of long positions, and 50% of the current market value of short positions.

The program which the New York Stock Exchange and the Commission have developed applies only to the New York Stock Exchange, which is only one part of the American securities market. On the smaller stock exchanges and in the over-the-counter market there are some 5,000 security brokers and dealers, many of whom transact business for the investing public. The smaller exchanges already are organized and able to apply to their own situations any changes necessary to the establishment of broker solvency for the protection of customers. With the cooperative program of the SEC and the New York Stock Exchange as a criterion, it should be possible for them to develop programs which fit their needs.

However, the widespread over-the-counter markets are almost wholly unorganized, and hence not in a position to establish self-government in these matters. Recognizing this lack of organization in a large part of our securities market, the last Congress amended the Securities Act by enacting the so-called Maloney Bill. Under this amendment, over-the-counter broker-dealers are permitted to establish their own voluntary organizations for self-government. Although none of these organizations have as yet been registered with the Commission pursuant to the Act, the SEC and the trade are actively cooperating in attempting to find the most suitable type of organization. Obviously such organizations, when established, could be of great benefit to the investing public by pursuing actively a program of protection for the investor through the enforcement of solvency standards for their members. Doubtless some parts of the SEC-New York Stock Exchange program are not suitable to the over-the-counter markets, but the experience gained in the application of that program should blaze a trail which the Maloney Act organizations may follow. Surely matters such as adequacy of books and records, filing of uniform financial statements, periodic inspections of books and records, the ratio between a broker-dealer's indebtedness and his capital, trading by broker-dealers for own account, information with respect to underwriting commitments, hypothecation and commingling of customers' securities, and the potential safeguards and economies to be obtained from central trust institutions are as important to the over-the-counter markets as they are to the organized exchanges. The Maloney Act appears to offer the over-the-counter market an opportunity to establish itself in its field as adequately and efficiently as the New York Stock Exchange is organized in its field.

It cannot be denied that functional speculation in securities is an integral part of what we call "capitalism". Nor can it be gainsaid that the speculative function has at times been pestered by parasites that have almost caused the public to burn down the house in order to kill the roaches. It is also clear that the "private club" type of security-market regulation has shown itself unable to defend the house against parasitic infestation. In the process of "protecting the investor" the SEC would be remiss in its duty unless it did everything within its power to cause real protection for brokers' customers to be established. An adequate program has been cooperatively created. An adequate method of cooperative procedure has been established. Let us hope that the results obtained will be commensurate with the cooperative effort which is being exerted.

W. M. Blaisdell

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